BEFORE THE WASHINGTON STATE

UTILITIES AND TRANSPORTATION COMMISSION

WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION, Complainant, vs. PACIFICORP d/b/a PACIFIC POWER & LIGHT COMPANY, Respondent.	)	DOCKET NO. UE-050684 Volume X Pages 1161 to 1399
In the Matter of the Petition of PACIFICORP d/b/a PACIFIC POWER & LIGHT COMPANY For an Order Approving Deferral of Costs Related to Declining Hydro Generation.	)	DOCKET NO. UE-050412 (Consolidated)

A hearing in the above matter was held on January 23, 2006, from 9:35 a.m to 5:15 p.m., at 1300 South Evergreen Park Drive Southwest, Room 206, Olympia, Washington, before Administrative Law Judges ANN E. RENDAHL AND THEODORA M. MACE and CHAIRMAN MARK H. SIDRAN and COMMISSIONER PATRICK J. OSHIE and COMMISSIONER PHILIP B. JONES.

Joan E. Kinn, CCR, RPR
Court Reporter

The parties were present as follows:

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P R O C E E D I N G S

JUDGE RENDAHL: All right, well, let's be back on the record this morning, Monday, January the 23rd, for another day of hearing in the PacifiCorp rate case matter, Docket Numbers UE-050684 and UE-050412 I believe it is, and we're here today to hear from three witnesses, company witnesses Mr. Hadaway and Mr. Williams and Staff's witness Mr. Rothschild. So is there anything we need to discuss on the record before we start with the witnesses?

MR. SANGER: Judge Rendahl, this is Irion Sanger on the telephone.

JUDGE RENDAHL: Good morning, Mr. Sanger.

MR. SANGER: Good morning, just wanted to let you know that we are available on the telephone, we do not plan obviously any cross-examination, but if any other issues come up, I am on the telephone.

JUDGE RENDAHL: All right, thank you very much.

MR. SANGER: Thank you.

JUDGE RENDAHL: We have just gone on the record, and I have just asked the parties if there's any preliminary issues we need to deal with before we begin hearing from the witnesses.

Mr. Wood.

MR. WOOD: Yes, Your Honor, at the end of the last hearing you stated a request by the Commission that the company, that I take back to the company a request for a limited waiver of the time period for deciding this case of one or two weeks. The indication was that given the tightness of the schedule, the difficulty of the issues, the Commission needed at least one week and two would be better in order to decide this case. During that discussion, an issue that had previously been raised and decided was brought up again, which had to do with the reply brief schedule time. The company recognizes the decisional realities here and the time, and there was a long discussion about this matter, and I would like to -- which means I should relate a couple points, the bottom line being that the company is willing to extend a limited amount of additional time, recognizing this case has gotten more complicated and there has been some compression of the time period.

The concern and the reason for the long discussions, the company believes that what it now has in its case after it's been scrubbed represents a minimum amount if the company is to hope to have a reasonable return and a reasonable return in this state. That being the case, the company views each week of delay based on what it hopes will be the final decision as having a cost of something in excess of $1/2 Million, a two week delay would be $1 Million. Obviously other parties view our points of view differently.

Having said that, the company recognizes and believes it's benefited by the Commission having enough time to carefully consider the arguments that are made, and particularly given the tightness between the time of the reply brief and the order, having a chance to review the replies to the opening brief. For that reason, the company is willing to extend the deadline for up to two weeks and to -- it's obviously -- it is the company's view to trust the decision by the Commission between its own decisional time and request for additional reply briefing as to what would be best to enable it to make its own decision whether it wants the full two weeks itself and retain the briefing schedule as previously set or wants to add some portion of that time to the reply brief believing that will -- they prefer that, and obviously the company has no opinion on that issue but is willing to extend for up to two weeks allocated as the Commission sees fit.

The one thing that is critical to the company in this waiver that I should point out is something that's already been ruled on, which is that the reply briefing page limits not be restricted from what the rule allows. It does little good to extend the time period so the Commission can consider our arguments and then disable us from making them. We believe the reply brief will be important given the number of parties and the things that we may have to address on reply. Having said that, the company, as long as it's able to submit a full reply brief, is willing to extend for two weeks allocated as the Commission sees fit.

JUDGE RENDAHL: All right, thank you.

Mr. Trotter, did you have any response to that?

MR. TROTTER: No, Your Honor.

JUDGE RENDAHL: Okay. I understood from a message you had sent me that you have reviewed the Commission's rules and that the reply brief is 60 pages.

MR. TROTTER: Just so the parties know, there was a discussion last week, it may have been off the record, where we were talking about a 25 page limit on reply briefs, and I did leave a voice mail with the Judge on the procedural matter indicating that I could find no support for 25 pages in the rule, and that was the extent of the communication. I believe I also noted that the rule called for a 60 page brief, and traditionally that's been the opening brief, so I think I may have just been thinking of the appellate procedural rules in that regard. So the issue of the length of the reply brief I think is open for discussion, and whatever the Commission feels would be useful to it is, of course, acceptable to Staff.

JUDGE RENDAHL: All right, well, we will have a discussion amongst ourselves at the break and let you know what our decision is in terms of how to allocate that time. We very much appreciate the company's willingness to extend that time.

MR. WOOD: I would also comment on the reply brief, Your Honor, that while it's important to the company they not be artificially restricted, we also understand that submitting a lot of pages that we don't need to submit does not assist our case, and we intend in the reply brief to take the time necessary to address arguments that are made in the opening brief as concisely as we can and stop.

JUDGE RENDAHL: And we appreciate that too for all parties.

All right, well, with that, is there anything else additional before we begin with the witnesses?

Hearing nothing, again, thanks very much, Mr. Wood, for that and for the company, and if Mr. Hadaway is here, Mr. Hadaway, if you could come forward and come to the stand.

(Witness SAMUEL C. HADAWAY was sworn.)

JUDGE RENDAHL: Okay, please go ahead and sit down.

THE WITNESS: Thank you.

JUDGE RENDAHL: Mr. Wood.

MR. WOOD: Thank you, Your Honor.

Whereupon,

SAMUEL C. HADAWAY,

having been first duly sworn, was called as a witness herein and was examined and testified as follows:

D I R E C T   E X A M I N A T I O N

BY MR. WOOD:

Q. Dr. Hadaway, your exhibits that were prefiled have been identified, your direct testimony as Exhibit 21-T and the four attachment schedules to that exhibit as Exhibits 22 through 25. Your prefiled rebuttal testimony has been identified as Exhibit 26-T, and the schedules and exhibits attached to that have been identified as Exhibits 27 through 37. And with respect to your prefiled testimony, I ask was this testimony prepared by you or under your supervision and direction?

A. Yes.

Q. Do you have any changes to make to that testimony?

A. I do not.

Q. All right. Is the testimony true and correct to the best of your knowledge?

A. Yes.

MR. WOOD: I would also identify for the record that there have been submitted cross-examination exhibits numbered 38 through 51, and the company has no objection to the receipt of any of these cross-examination exhibits. I would offer Exhibits 21-T through 25, 26-T through 37, and if it's the appropriate time would not object also to the admission of Cross-examination Exhibits 38 through 51.

JUDGE RENDAHL: All right, well, is there any objection to admitting what's been marked as Exhibits 21-T through 51?

MR. FFITCH: Your Honor, Public Counsel just has one clarification. I note on the exhibit list that Public Counsel Exhibit 47 is listed as the response to Staff DR Number 1, and that should read Staff DR 16.

JUDGE RENDAHL: All right, I have on my list Staff Data Request 16, and then 48 is Public Counsel Data Request 16, so I don't know how it came through on your list, but I have it correctly.

MR. FFITCH: All right.

JUDGE RENDAHL: So for purposes of the official list I think it's marked.

All right, so with that, there are no objections to admitting those exhibits?

Hearing nothing, Exhibits marked 21-T through 51 will be admitted.

MR. WOOD: Your Honor, Dr. Hadaway is available for cross-examination.

JUDGE RENDAHL: Thank you.

Mr. Trotter.

MR. TROTTER: Thank you.

C R O S S - E X A M I N A T I O N

BY MR. TROTTER:

Q. Good morning, Dr. Hadaway.

A. Good morning, Mr. Trotter.

Q. One of the issues that separates Staff and the company in this case is the issue of whether or not to use GDP growth as an indicator of long-term growth in calculating cost of capital; is that right?

A. Yes.

Q. Would you turn to page 10 of your rebuttal, which is Exhibit 26-T, and starting on line 13 you refer to a textbook by Professors Brigham, B-R-I-G-H-A-M, Gapenski --

JUDGE RENDAHL: Mr. Trotter, I'm sorry, can you tell us what page number you're referring to again?

MR. TROTTER: Page 10.

JUDGE RENDAHL: Thank you.

BY MR. TROTTER:

Q. This will be page 10 of 26-T, and you refer on the bottom half of the page to a textbook written by Professors Brigham, B-R-I-G-H-A-M, Gapenski, G-A-P-E-N-S-K-I, and Ehrhardt, E-H-R-H-A-R-D-T; do you see that?

A. Yes, sir, I do.

Q. And you use this textbook to support your use of GDP growth; is that right?

A. That's one of my explanations for using it.

Q. Turn to Exhibit 38.

A. Mr. Trotter, I'm not sure if my exhibits are marked exactly like yours, but if you will be patient with me, I will be happy to try to get to that.

Q. It's the company's response to Staff DR 316; do you have that?

A. I believe I do.

Q. And you indicate on the first page that the book that you refer to in your testimony was dated 1999?

A. Yes, sir, that's right.

Q. And the second page of the exhibit is an excerpt from that book which contains the quote that you provide on page 10 of your rebuttal?

A. That's right.

Q. And in the quote about six lines down, the authors conclude that:

One might expect the dividend of an average or normal company to grow at a rate of 6.8% a year.

Do you see that?

A. I'm sorry, 6% to 8%.

Q. Yes.

A. The range.

Q. And that is according to the authors the same rate as what they expect the nominal gross domestic product or real GDP plus inflation to be?

A. I believe that's their comment there, and I have also shown that that is indeed the rate from the Saint Louis Fed data.

Q. And could you turn now to page, excuse me, Exhibit 32.

MR. WOOD: Again, I don't believe it's -- you might indicate which data request.

MR. TROTTER: SCH-12.

JUDGE MACE: It's his own exhibit.

MR. WOOD: Oh.

BY MR. TROTTER:

Q. Do you have that?

A. Yes, sir, I do.

Q. And here you show historical values for long-term -- for GDP growth for several years in sequence?

A. Yes, sir.

Q. And if we look at the nominal GDP column for 1999, it was 9409.1; do you see that?

A. That's the dollar amount.

Q. Yes.

A. Yes.

Q. And then for 2004 it was 11919.7; do you see that?

A. Yes, I see that.

Q. Would you accept subject to your check that the compound annual growth rate in GDP from 1999 through 2004 was therefore 4.84%?

A. Might I just do that calculation for you?

Q. Sure.

A. 4.84%.

Q. Yes.

A. That's correct.

Q. Thank you. And that's below the 6.6% GDP growth rate you used in your DCF method as well as the

6% to 8% range from the text you cite; is that right?
A. Yes, it certainly is, it's during the lowest inflation period we have had though in the entire 47 year period there.
Q. Okay. And then below the 2004 year, you show a ten year average GDP growth of 5.2% and a 20 year average of 5.6%; do you see that?
A. That's right.
Q. Going back to the textbook page, the beginning of the quote, and it's also in your testimony rebuttal on page 10:

> Expected growth rates vary from company to company, but dividend growth on average is expected to continue in the foreseeable future at about the same rate as that of the nominal GDP.

Do you see that?
A. Yes, sir, I do.
Q. Would you accept subject to your check that according to the December 26, 2005, issue of Barons the current dividend yield on the S&P 500 is 1.83%?
A. If you make that representation to the Commission, I certainly --
Q. You can accept it subject to your check?
A. Well, I don't know that I will check it.

Q. Okay.

A. But if that's what you say it is, I certainly will take that.

Q. Okay, thank you. And if we added your 6.6% growth rate to the S&P dividend yield so recorded, that would give a DCF result for the S&P 500 of around 8.4%, correct?

A. Mathematically, Mr. Trotter, but that's not a correct calculation, because many of the companies in the S&P don't pay dividends, many of them simply are not amenable to using the DCF model.

Q. Would you accept that the same edition of Barons reported the dividend yield on the Dow Jones utility average at 3.19%?

MR. WOOD: Your Honor, I think I will object, I don't know that Barons, whether Barons' numbers are accurate or not accurate, I don't think it's likely the witness is ever going to check them. If there's --

MR. TROTTER: I have -- go ahead.

MR. WOOD: If there's an article that he wishes to have the witness review perhaps at a break and ask him questions about it, that would be fine. But taking numbers out of an article the witness has ever seen that's not an official reporting entity anyway and asking a hypothetical seems inappropriate.

JUDGE RENDAHL: Mr. Trotter.

MR. TROTTER: Well, first of all, I have the Barons edition if he wishes to look at it. It's simply a reported figure, and we're just trying to show what the dividend yield for the Dow Jones utility average is, and we believe Barons is reputable for reporting that statistic.

JUDGE RENDAHL: Well, the information seems relevant, and so it doesn't seem that's your objection though.

MR. WOOD: No.

JUDGE RENDAHL: Your objection is that he's not prepared because he doesn't have the same information in front of him.

MR. WOOD: That is correct, and my suggestion is if he wants to ask him questions about Barons that at least the witness can be given an opportunity during a break to look at the document that he's quoting from so he can understand the numbers in context.

JUDGE RENDAHL: Mr. Trotter, do you have a separate copy of that?

MR. TROTTER: He's welcome to this one, Your Honor.

JUDGE RENDAHL: All right, why don't we take a short break while we get the copy in front of the witness, let's be off the record.

(Discussion off the record.)

JUDGE RENDAHL: Mr. Trotter.

BY MR. TROTTER:

Q. Okay, the question pending was whether Barons was reporting the dividend yield for the Dow Jones utility average to be 3.19%?

A. This appears to be based on a December 26th, 2005, version of --

Q. Yes.

A. -- of Barons.

Q. Yes.

A. They show that number along with a lot of other yields and other items.

Q. Okay.

A. My hesitation, Mr. Trotter, is that the dividend yields in both Mr. Rothschild's testimony and in my testimony for electric utility companies that we use are up in the 4%, 4 1/2% to 4.7% range I believe. So 3.9% or 3.19% which you're pointing to here is lower than that, but I'm not sure that I would agree that it is on point with respect to what we were trying to do.

Q. I understand, but do you accept that that's the number they're reporting?

A. Well, I don't accept it, I see it, yes, that is the number they're reporting.

Q. And if we applied your GDP growth figure of 6.6% to the Dow Jones utility average dividend yield, we would obtain a DCF for the Dow utility average of around 9.8%, is that right, 6.6% plus 3.19%?

A. Yes, mathematically you would, and I have explained in my testimony why that's not an appropriate thing to do.

Q. Turn to page 11 of your rebuttal, Exhibit 26-T, beginning on line 3 you indicate your view that current analysts' growth projections are much lower than they were just four years ago, and on lines 12 and 13 you say:

> Such dramatic changes in growth rates seem unlikely in estimates that might be used to measure long-term growth rates as required in the DCF model.

Do you see that?

A. Yes, I see that.

Q. And just above that quote you show two figures, an average growth rate in 2001 of 5.3% and as compared to 3.3% in 2005; do you see that?

A. Yes, Mr. Trotter, those come from my Exhibit SCH-11.

Q. Okay.

A. Which explains where they came from.

Q. Right, that may be one source, but could you turn to your Exhibit 24, which is SCH-4, page 2, and, well, what exhibit did you say?

A. It's the one that in my copy is marked Exhibit SCH-11, which is the rebuttal exhibit that shows the decline in analysts' growth rates of over 2% has occurred. You asked me about the bottom panel of that. The top panel is actually the part that shows what analysts' growth rates have declined by.

Q. If we could go to Exhibit 24, SCH-4,

A. Okay, the question you asked me was out of my rebuttal testimony.

Q. Yes.

A. And now we're going back to the exhibits in my direct testimony, correct?

Q. Yes.

A. Okay, thank you.

Q. And I want to focus on that 3.3% figure from page 11 of your testimony, and am I correct that that can be calculated by looking at Exhibit 24, page 2, the B times R growth column, and taking the values shown there but excluding three companies, the one on line 4, Cleco Corporation, Entergy on line 8 excluded and Exelon on line 9?

A. I'm not sure, Mr. Trotter. The exhibit that supports the testimony you asked me about is not that exhibit, it's Exhibit SCH-11.
Q. But that --
A. Which is attached behind my rebuttal testimony.
Q. But the source for Exhibit 24 is the same, isn't it?
A. At a different time and for a different set of companies.
Q. Okay, looking at your Exhibit 31 in the bottom half for the 2005 column, your source there is Value Line for September 2nd, 2005, whereas Exhibit 24 you're showing March, April, and February of 2005; is that right?
A. That's right.
Q. Okay.
A. And as you said, there are three companies, they had the Entergy and Cleco Companies were affected by the hurricane matter, and Exelon is in the midst of a merger that has sprung up since then. So my rebuttal sample is down to 14 companies instead of 17.
Q. Switching subjects, Dr. Hadaway, the DCF model recognizes that investors obtain value either through the dividend or through future growth, correct?

A. Perhaps through a future sales price predicated on future growth.

Q. Earnings paid out as a dividend are no longer available to the company for reinvestment; is that correct?

A. Correct.

Q. The rest of the earnings that are not paid out as a dividend are used, able to be used by the company to help create growth, correct?

A. That's one of the things, yes.

Q. The greater the portion of earnings paid out as a dividend, all else equal, the smaller the growth, correct?

A. Be careful of all else equal, but yes, under that assumption.

Q. And the greater portion of earnings paid out as a dividend, the larger the dividend yield, again all else equal, correct?

A. I think that's correct by definition, yes.

Q. Please turn to Exhibit 39, which is your response to Staff DR-317.

A. I think I have that.

Q. And turn to page 2.

A. Okay, I have that.

Q. And you developed a group average growth rate of 5.27 based on this exhibit; is that right?

A. Yes, this is one of the four growth rates that I used in my initial look at the constant growth DCF model based on traditional methods, a result that I ultimately excluded from my range because it's more than 100 basis points below the risk premium test of reasonableness.

Q. But the retention rate is based on historical data, is it not, the third column of figures?

A. It's based on Value Line's projected three to five year future retention rates.

Q. Okay. And future as of 2001 according to your source note at the bottom?

A. This is the, yes, B/R calculation that we used to demonstrate what the B times R method gave back in 2001.

Q. Okay.

A. That's what supports that Exhibit 11 we were talking about before.

Q. Okay. But the source of the retention rate is what Value Line was predicting in 2001?

A. That's exactly right.

Q. Okay. And so, for example, for Alliant Energy on line 1, to get the B times R growth in the last column, you multiplied the retention rate of 31.03%

times the ROE of 9.91% to get what rounds to 3.08?

A. Yes, sir.

Q. And on line 8 there's no entries for MGE Energy, is that right?

A. That's right.

Q. So there's 13 companies with reported data here?

A. That's correct, yes.

Q. Would you accept that the average retention rate for the 13 companies reporting data here is 41.72%?

A. It appears to be in that range.

Q. Would you accept it subject to your check?

A. If you would like for me to check it, I will be glad to do so. It appears to be what that is.

Q. Just for your information, under the rules you have a period of time after the transcript is received to check, and you can either accept or not accept; is that acceptable to you?

MR. WOOD: One question about the retention rate, because I have seen different numbers, for example Mr. Rothschild's, is when one asks about an average, it's not clear whether you are asking about each of these retention rates divided by 13 or --

MR. TROTTER: Yes.

MR. WOOD: -- or whether you're asking for a weighted average or what.

BY MR. TROTTER:

Q. Add them up and divide by 13.

A. I will be happy to do that.

Q. Okay. So in other words, back in 2001 Value Line was expecting these companies would retain on average 41.72% of the future expected earnings; is that right?

A. If your calculation is right, that's right.

Q. Let's go back to Exhibit 24, page 2?

A. I'm sorry --

MR. WOOD: SCH-4.

Q. SCH-4.

A. Mine are just not marked that same way.

Q. And here you show for the 17 companies for the retention rate an average of 32.81%; do you see that?

A. Yes, in column 6 I see that.

Q. Thank you. And that's based on 2005 data?

A. That's based on Value Line's forecast as of 2005. It's actually for the period I believe 2008 to 2010, it's three to five years out.

Q. An analyst who expects the retention rate to decline from 41.72% in 2001 to 29.66% would also expect a considerably lower dividend growth rate, correct?

A. Well, they would actually expect a lower earnings growth rate, but that's what we all use to try to estimate expected dividend growth rates. They would also have to look at what the expected earned rate of return was. But back in that Exhibit 11 we started out talking about I made these very same calculations, that's where the numbers come from.

MR. TROTTER: Those are all my questions, Dr. Hadaway, thank you very much.

THE WITNESS: Thank you.

JUDGE RENDAHL: Mr. ffitch.

MR. FFITCH: Thank you, Your Honor.

C R O S S - E X A M I N A T I O N

BY MR. FFITCH:

Q. Good morning, Dr. Hadaway.

A. Good morning, sir.

Q. Simon ffitch with the Office of Public Counsel. You testified in PacifiCorp's 2004 rate case, or maybe I should say 2003 based on the start date, that was Docket Number UE-032065; is that correct, Dr. Hadaway?

A. I filed testimony, I believe the case may have settled, I'm not sure if I testified here.

Q. All right.

A. But I did file testimony, yes.
Q. Yes, you filed testimony in that last PacifiCorp rate case?
A. Yes, sir, I did.
Q. All right. And in that case you recommended a cost of equity or an ROE of 11.25%; is that correct?
A. Yes, sir.
Q. And in this case you're recommending 11.125%; am I right?
A. That's right.
Q. So your testimony indicates the capital costs have declined somewhat since the company was most recently before the Commission, right?
A. Slightly, yes.
Q. Now in this case you updated your cost of capital analysis in your rebuttal testimony, but your ROE recommendation did not change, correct?
A. The two DCF models that I relied upon actually gave slightly stronger results in the rebuttal update, so no, we didn't change the recommendation.
Q. All right. Now your direct testimony in this case was filed in May 2005, correct?
A. Yes, sir.
Q. And so obviously you prepared that prior to May 2005, and you were using data from January,

February, March time frame; is that right?

A. Yes, sir, that's right.

Q. And so again, your testimony is that the cost of equity hasn't changed since that time?

A. My testimony as I sit here is that interest rates are exactly the same as they were at the time when we filed that testimony.

Q. All right.

A. So overall capital costs have not changed, in fact they had firmed up a bit when we did the rebuttal testimony, now they have smoothed back out to just about where they were before November.

Q. Can I ask you to please turn to Exhibit 24, which is your SCH-4, and go to page 1 of that exhibit; do you have that?

A. Yes, sir, I have it.

Q. And there in the first column you show a standard or traditional DCF average of 9.3% at the bottom of the first column and a median or middle value of 9.5%; is that right?

A. Yes, sir.

Q. Now can I ask you to turn, please, to page 11 of your direct testimony in this proceeding, which is Exhibit 21-T I believe, go to line -- do you have that?

A. Yes, sir, I have it.

Q. Okay, and I'm looking at line 21, and there you state that the DCF model is the most widely used approach in regulatory proceedings, right?

A. I do.

Q. Now can I ask you to please turn to Exhibit 48, and that's one of our cross-examination exhibits that's been marked for you, that's Data Request 16; do you have that?

JUDGE RENDAHL: It's the Public Counsel Data Request 16.

MR. FFITCH: Correct, it says WPC on it, which is the company's shorthand for Washington Public Counsel I believe, that would be Exhibit 48 or Data Request 16, WPC Data Request 16.

MR. WOOD: Dr. Hadaway, I think in the package you have it will immediately follow the exhibits to the testimony you were just being asked about.

A. I have that now, thank you.

BY MR. FFITCH:

Q. All right, and there we simply ask you to provide support for the statement in your testimony that we have just read regarding the use of DCF, and your response in the data request is that it is based on your experience in regulatory proceedings around the country, correct?

A. That's correct.

Q. And your experience is pretty extensive, isn't it, if we look at Exhibit 22 we see that you have quite a bit of experience in this field?

A. I have been doing it since 1980, yes.

Q. All right. Now if we could look back, please, to page 17, maybe we don't -- I can direct you back to a quote, but essentially back in your direct testimony, Exhibit 21, you state that in estimating the cost of equity capital you rely principally upon the DCF model and use the risk premium as a check of the DCF; is that essentially your testimony, Dr. Hadaway?

A. Yes, I'm sorry, what page is that on?

Q. I'm happy to direct you back to that, it's page 17 of your direct, Exhibit 21-T.

A. Okay, I'm with you now.

Q. Okay, and it's lines 17 and 18. Do you want me to repeat the question?

A. No, I understood, that's what it says, yes.

Q. All right. Now we noted earlier that you testified last year or in the preceding case in any event for PacifiCorp with regard to the cost of capital, and your testimony in this case is somewhat different than your testimony in the last case, isn't it, Dr. Hadaway?

A. We have eliminated one of the models that we used at that time, and we have enhanced the use of the GDP growth rate since that time.

Q. All right. And the model you used last year or in your testimony, you used a model in which you performed a standard or traditional DCF analysis using analysts' projected growth rates, sustainable growth and a long-term GDP growth average; is that correct?

A. At that time I only had 20 years of data for the GDP growth rate, so that's the principal difference.

Q. Okay. And I'm not sure if this has been done on the record yet, but GDP is gross domestic product; isn't that right?

A. Yes, that's right.

Q. And that's essentially a measure of the entire national economic output?

A. Yes, sir.

Q. Can I ask you now to turn, please, to Exhibit 49, that again is one of Public Counsel's cross-exhibits for you, and that's a response to Data Request 11. Do you have that? I'll give you a minute.

A. The one that I see after the testimony appears to be Data Request 177, is it beyond that or --

Q. Go back the other direction, it's two before that, that's 51 and I'm at 49.

A. I have that now, thank you.

Q. All right. And this is the data request that Public Counsel asked you about this difference, the request asks if since you last testified in Washington your analytical methodologies have changed and then asks you for an explanation, and you provide an explanation in that answer, correct?

A. I do, yes.

Q. And we have touched on this already, but if we look down in the middle of this response, we see a sentence that starts, relative to the versions of the DCF models; can you find that?

A. Yes, Mr. ffitch, I see it.

Q. All right. So if you would like to, rather than me read it, why don't you read that sentence down to where it says 100 basis points, that I think summarizes your explanation of the different or the reasons for the different methodology, starting with relative to the versions, can you read that into the record.

A. I think this is the explanation of why I'm not using the market price model, Mr. ffitch, the sentence beginning just before that, but it says:

Relative to the versions of the DCF models used in the prior case, the principal change is incorporating the GDP forecast as the long-term "g" value. This change from analysts' growth rates and the sustainable growth ("b times r") method based on Value Line's projected retention rates and earned ROE's was made because the low inflation environment and pessimistic analysts' estimates have caused the previous growth rates to drop by over 100 basis points.

Q. Okay, thank you.

Now can I ask you, please, to turn to Exhibit 35, that is your SCH-15.

A. I have that.

Q. Do you have that?

A. Yes, sir.

Q. And go to page 1, please, and this is your -- this is simply your DCF cash flow analysis exhibit for your rebuttal testimony similar to the one that we just looked at for your direct, right?

A. That's right.

Q. And this shows your updated DCF numbers, and at the bottom in the first column headed traditional constant growth DCF model, at the bottom of that we see a 9.3% average result of the analysis, right?

A. Mr. ffitch, you see that there, but as I explained and used Exhibit SCH-11 to demonstrate, the analysts' growth rates used in that analysis rendered it not appropriate because it falls well below the risk premium checks of reasonableness. Using Exhibit SCH-11, rebuttal Exhibit SCH-11, I demonstrate clearly that the analysts' growth rates have dropped by over 200 basis points since the prior case.

Q. Okay.

A. From when they were very much like growth rates in gross domestic product, how they are that much lower as a perpetual growth rate, that's simply not a reasonable drop in a matter of three to five years.

Q. Okay, and I understand that's your argument, so if you will bear with me here as I work through some of these exhibits, we'll just examine that a bit further. This analysis here that's under the traditional constant growth model, again on Exhibit 35, that uses the average of the analysts' projected earnings growth, the projected sustainable growth, and your estimate of the GDP growth as the DCF growth rate, correct?

A. And there's one more, also Value Line's, there are four of them.

Q. Oh, okay.
A. Value Line's projected earnings growth.
Q. All right. Now if we go to the second column on this page, which is the constant growth DCF model, the long-term GDP growth calculation, this indicates that the rate is 11.2%, it's about 200 basis points higher obviously than the traditional model in the first column, right?
A. That's because the analysts' growth rates are now 200 basis points lower than they were.
Q. And so in your, obviously I think as you have just stated, in your recommended ROE results in this proceeding compared to your recommendation in the last rate case, you have elected to replace the traditional or standard constant growth DCF model with the long-term GDP growth model for the basis of your recommendation, correct?
A. No, Mr. ffitch, that's not quite right. In the prior case we had a model that a professor at the University of Florida, Dr. Radcliff, has in his textbook, and some commissions use that model. Rather than running the DCF model all the way out to infinity which is very difficult to do, Professor Radcliff suggested that people are going to sell the stock after a certain period of time. So he determines a terminal

price, thus the name of that model. That model is extremely sensitive to that terminal price estimate, and it turned out that most of us that tried to use it were always under attack, either we used too high or too low or something about the way we estimated that future price that didn't suit people.

Q. All right.

A. Quite frankly, I came to somewhat agree with that, the model is too sensitive to that terminal price, so we have taken that out. I have replaced it with the Oregon low near term dividend two-stage growth model if you want to think of one as being a replacement. I have simply eliminated the constant growth model.

Q. All right, so it's your testimony that in the last PacifiCorp rate case docket you used something called a term price estimate model rather than --

A. I think we called it either the market price model or the terminal price model.

Q. And your testimony is that's something different than the traditional constant growth DCF model?

A. Yes. I could be confused in terms of which case I'm thinking of, but we have used that model, we have taken it out, it was one of three that we have used in historical cases, and we do not use it any more.

Q. All right. But in other words, you didn't use the GDP only growth rate in your DCF analysis in the last case, did you, to --

A. I don't believe we did. We used a 20 year GDP growth rate as part of the estimation of long-term growth.

Q. All right. Now we have just taken a look at your response to Public Counsel Request 11, Exhibit 49, and that's your explanation of why you have changed your methodology, and one of the statements you make there, one of the justifications you provide is that this was made:

> Because the low inflation environment and pessimistic analysts' estimates have caused the previous growth rates to drop.

Is that right?

A. It's principally the drop in the analysts' growth rates, but that is the answer we gave, yes.

Q. Wasn't there a low inflation environment last year as well, Dr. Hadaway?

A. There has been for quite some time now.

Q. And also, again this is Exhibit 49, in your response to our inquiry one of the reasons you gave or you give, do you have that still?

A. Yes.

Q. Sorry.

A. Thank you.

Q. Didn't mean to inquire without you having it.

One of the reasons you give, one of the additional reasons you give for relying on long-term growth, domestic product growth is that long-term growth rates shouldn't fluctuate that much, right?

A. Growth rates expected by investors to infinity as required by the traditional DCF model should not fluctuate that much.

Q. All right, and that's the second to the last sentence of this response where you make that observation.

A. That's right.

Q. Isn't that right?

A. Yes, that's where you had me stop reading before, yes.

Q. I guess if that's the case, why did you use 6% for a long-term GDP growth in the last case in your analysis and then 6.6% in this case?

A. I had 20 years of data, which as you suggest, suggested earlier, was based on the most recent data, which have very, very low inflation rates in them. So the growth rate nominal GDP if we just look at the most recent 10 years that Mr. Trotter asked me about earlier or the most recent 20 years is lower than the long-run average. The estimate that I provided in my rebuttal testimony to get to 6.6% takes all the data that the Saint Louis Federal Reserve data base has going back to 1947, and it does a weighted average giving more weight to more recent periods, because I think that's appropriate, but it doesn't ignore the previous years, 37 years, that I did not have previously.

Q. Okay, and let's just follow up on that a bit. If you could please look at Exhibit 24, which is your SCH-4, and this time go to page 5 of 5.

A. Sorry, it's taking me just a moment here.

Q. That's fine.

A. SCH-4, page 5 of 5?

Q. Correct.

A. I have that, yes.

Q. Column descriptions, this is headed DCF analysis column description, right?

A. Yes.

Q. And the columns that are referred to are earlier in the exhibit, the different parts of your spreadsheets; isn't that right?

A. That's right.

Q. Okay. Let's look at column 12, and I think this is what you were perhaps just discussing, column 12 is described as the average of the GDP growth during the last 10 year, 20 year, 30 year, and 40 year growth periods, correct?

A. Yes, sir.

Q. Now can I ask you to turn to Exhibit 35, I believe it is SCH-15, and this is page 5 of that exhibit, the comparable column descriptions for your rebuttal DCF analysis.

A. Yes, sir, I think I have that.

Q. All right. And if we could look again at the column 12 description, this time it says average of GDP growth during the last 10, 20, 30, 40, and then adds 50 year and 57 year growth periods, so that does calculate the GDP growth rate differently, does it not?

A. No, the first one is an error I believe. The 6.6 doesn't change, it's calculated as this rebuttal description of the columns says that it is.

Q. All right, so which one is in error, this --

A. I believe the first one in the direct testimony. It just failed to say that we added up all those various periods which gives 5 times the weight to the last 10 years, 4 times the weight to the last 20 years, and so forth, but it's just a weighted average of the data that are in that exhibit.

Q. Okay.

Can I ask you then to please turn to Exhibit 32, which is your SCH-12.

A. I have that, yes, sir.

Q. And this contains the long-term GDP growth data that you used in your analysis, correct?

A. That's correct.

Q. And --

A. In both the rebuttal and the direct, there's no change.

Q. All right.

A. From one to the other.

Q. And this shows, does it not, that over the past 10 20 year periods there has been a decline in GDP growth, right, does it not, we can see the averages down at the bottom?

A. Yes, that reflects the much lower inflation rate that has occurred more recently.

Q. Okay. So if you add more data from older time periods, then the average GDP will increase, correct?

A. In this particular case, it will, because the most recent 20 years is much more influenced by the low inflation environment we have had. If we go back 75 years, which the Ibbotson data do, you will find that they are more like the 47 year period than they are the last 20 years. The inflation rate has been historically about 3%, and the last 20 years has been lower than that.

Q. Okay.

I would like to just look at a little bit of the theory behind the standard traditional DCF model, and could you turn back to your direct testimony, Exhibit 21, at page 13.

A. Okay.

Q. And I'm looking at lines 5 through 8, and there you state, well, first of all, lines 7 and 8, you state that g is the long-term expected dividend growth rate, correct?

A. In the derivation of the model, yes, it is.

Q. All right. And then just sort of looking at that entire section there, lines 5 through 8, the equation immediately above is I guess you state there the familiar constant growth DCF model essentially stating that the return on equity is equal to the sum of the expected dividend yield and the long-term expected dividend growth rate; is that right?

A. That's right.

Q. And your rationale for using the long-term GDP growth rate is that instead is, excuse me, instead of the traditional model is that it is a more stable measure of long-term dividend growth rate than analysts' projections; am I following your testimony?

A. That's one reason. The other reason is that no analysts' growth rates go beyond five years, and three to five years certainly has an influence on investors' long-term expectations, but in a period of exceptionally low environment, inflation environment, investors haven't forgotten that there can be periods when inflation is higher than that. So it is my belief that the GDP, long-term averages of GDP growth are more stable, they certainly are, than analysts' growth rates, but in addition to that they're more appropriate because they match what analysts' growth rates were five years ago, and they tend to not change. Obviously they're longer term so they don't change as much as three to five year estimates do, so I think that's more appropriate as an estimate of the long-term investor expectations.

Q. Now Mr. Hill comments on your testimony, and he indicates that one problem with your use of GDP growth is that you haven't shown that it provides a reasonable proxy of long-term growth for utilities. Is that a fair summary, one of his critiques?

A. I'm sure Mr. Hill said that.

Q. Okay.

A. His testimony is very long, and I don't recall that exact phrase, but that's fine, I will accept that.

Q. Well, my question is, can you direct me to a portion of your rebuttal testimony where you address that particular concern?

A. I think I attempted to show again in rebuttal Exhibit SCH-11 the dramatic drop that has occurred in analysts' growth rates. I have tried to demonstrate that that drop should not be expected in a perpetual growth rate. Mr. Hill and others prior to that drop would average in historical data, historical very low dividend growth, and other things like that that they don't have to do any more because analysts' growth rates now have dropped, at least in the near term, to the numbers that they have found all along. But their approach is, Mr. Rothschild and Mr. Hill's approaches have changed because now there's no use typically of historical growth rate data as was typically used five years ago.

Q. It sounds to me like what you're describing in SCH-11 and in your answer is a reason why, again why you are not comfortable using analyst expectation measures. But my question was, where in your rebuttal testimony do you establish or try to show that the use of GDP growth, affirmatively show that the use of GDP growth is a reasonable proxy of long-term growth for utilities?

A. It's very difficult to demonstrate what people expect because we can't measure it, we have to estimate it, and my Exhibit 11 I think is my best effort. The words where I respond to the other witnesses in terms of their criticism of my testimony may be responsive to your question, but I'm not sure that I know anything to say other than at one time GDP, long-term GDP growth rates and analysts' estimates for utilities future growth rates three to five years in the future were consistent, they are not now. At that time, lower growth rates in the DCF analysis were only obtained by averaging in five years and ten years of historical data for either the B/R analysis or simply for looking at what the growth rate averages were. People criticized analyst estimates at that time on one side of these cases as being too high, that analysts were overly optimistic. Now they use those estimates and they I guess don't think they're overly optimistic any more.

Q. But wouldn't you agree with me that one premise of your using the overall growth rate of the economy, the gross domestic product, is essentially the premise that the growth rate of all firms, utilities included, will approximate the growth of the general economy; you have to find that to be a reasonable premise in order to use your methodology, don't you?

A. That goes back to the Brigham and Gapenski quote where they said 6% to 8% is good for the average company, is what they would expect the growth rate to be in the very long-term for the average company. I haven't used the 7% average number, I have used 6.6%, which is less than a 6% to 8% range. It's in the range, but it's in the lower part of it. So I'm not claiming that every utility can grow at the same rate as the overall economy, typically don't, retention rates and things that I was asked about before tend to affect that. But the utility industry is changing, and retention rates are probably going to be higher in the future, who knows what earned rates of return may be in the future. Some of the analysis in this very case now uses a lower earned rate of return than it did just a few years ago. So all these factors change, Mr. ffitch, and I think something more stable like nominal gross domestic product and perhaps in the lower part of the historical range of that is a reasonable estimate of investors' growth rate expectations.

Q. I would like to address something that the next, an area that you have already I think touched on and if I can get you to turn back to once again to Exhibit 49, which is our Data Request 11 that it looks like the Judge may be able to help you out there again. Now we have been discussing some aspects of your DCF that you included this year but didn't include last year, and now I would like to turn to this area that you used last year but omitted this year, and this is what you I think have referred to as the market price or the terminal value version of the DCF; is that right?

A. That's right.

Q. And you actually right in the middle of this responsive paragraph immediately before the quote you read earlier, you state:

> The market price or terminal value version of the DCF model is not used in the current analysis.
>
> Right?

A. That's right.

Q. So you included it last year, but you left it out this year, would that analysis have increased or decreased your DCF equity cost estimate?

A. It would depend on how you determined the terminal price. If one averages price earnings ratios from Value Line's forecast and from their current P/E ratios that they present, the numbers are about the same as some of these. If one goes back and uses historical P/E ratios, as some did in the critique of my testimony, you can get much lower numbers. The model is extremely sensitive, and most analysts who have tried to adapt that model to use in rate cases so far as I know have stopped using it for that reason.

Q. You used it, again, in the last PacifiCorp rate case though, correct?

A. I had in several cases probably three to five, six years ago.

Q. Okay.

A. All of us have struggled with a constant growth DCF model and why it's the way it is. Alternative multistage growth models of various kinds have been offered, and Dr. Radcliff offered that one that some of us tried to use, and I do not use it any more.

Q. Did you in preparing your testimony in this case perform the market price or terminal value analysis and then decide to leave it out, or did you just decide to leave it out before you ever got to this case?

A. We decided to leave it out well before we got to this case, and I did not perform that analysis at all having to do with this case until I saw Mr. Rothschild's criticism.

Q. Would you be surprised to know that the result of that analysis is an average ROE estimate of 9%?

A. Absolutely depends on which terminal value you use. The calculation, and maybe I'm blaming Mr. Rothschild for something Mr. Hill did, but the analysis where the P/E ratios claim to be the way I did them before was indeed not that. They were based on P/E ratios collected by, through either Mr. Hill or Mr. Rothschild, whichever one of them did that critique.

Q. All right, well, I'm going to ask you to turn to Exhibit 50, please, Public Counsel cross-exhibit. Do you have that?

A. I'm with you.

Q. All right. This is an illustrative exhibit prepared by Public Counsel with Dr. Hill's assistance, and I will just represent that this is an effort to replicate your market price analysis from the last docket using the same model that you used and the data you have supplied for the companies in your updated cost of equity analysis in this docket. And if you look at the results, bottom right-hand corner, this shows, does it not, an average ROE of 9% and a group median for these listed companies of 7.5%?

A. Mr. ffitch, I have to say two things. First, I need to apologize to Mr. Rothschild, because I thought he had prepared this exhibit. Secondly, this exhibit is incorrect. The daggered point that says current P/E ratio is not the way we did the P/E ratio in the prior case, simply a mistake by Mr. Hill. You put a higher price to earnings ratio into this model, it gives a much higher ROE. If you put a lower price to earning ratio in this model, it produces a lower price out in the future, which gives the investors an implied lower return. It's terribly sensitive to that assumption, and Mr. Hill, I'm sure just on oversight, but he did not do the P/E ratio the same way I did in the prior Washington case.

Q. All right, now I would like to move on to another methodology, yet another methodology.

JUDGE RENDAHL: Mr. ffitch, would this be a good time to take our morning break before you turn to different topics, or where are you in your questioning?

MR. FFITCH: I have a few more questions on another area or two, so this would be a good time for a break, thank you.

JUDGE RENDAHL: All right, let's take our morning break, and we will be back at 11:00, we'll be off the record.

(Recess taken.)

JUDGE RENDAHL: We will be back on the record after our mid-morning break. I will note for the Bench there's a replacement for Exhibit 75, this is for Mr. Williams.

Mr. Trotter.

MR. TROTTER: Yes, Your Honor, we just included the wrong attachment, so we're just substituting this document for the prior document. The prior document can be eliminated. We provided copies to the company and other parties.

JUDGE RENDAHL: All right, thank you for that clarification.

And during the break we have a decision on the company's allocation of two weeks of additional time, and at this point because of our scheduling we won't be extending the briefing deadline at this point, and the parties can choose to write more or less in their briefs, in their reply briefs, but we're not going to put a limit on the briefing, and of course briefer is better.

MR. TROTTER: Your Honor, by no limit, you mean no limit in addition to what's already contained in the rule?

JUDGE RENDAHL: We're not going to reduce the 60 page limit.

MR. TROTTER: Thank you.

JUDGE RENDAHL: All right, with that, we're resuming Mr. ffitch's cross-examination of Dr. Hadaway, please go ahead, Mr. Ffitch.

MR. FFITCH: Thank you, Your Honor.

BY MR. FFITCH:

Q. Dr. Hadaway, let's stick with the last matter we were discussing, and we were looking at Exhibit 50, which is an illustrative exhibit prepared by Public Counsel related to your market price approach for DCF analysis. Do you have that in front of you? It's Exhibit 50.

A. I know just what it looks like, but I don't see it here.

Q. Okay.

THE WITNESS: Judge Mace, did you pass that to me before?

Q. I'm also going to be asking you about Exhibit 46, which is the testimony from the last PacifiCorp case with the exhibits, so just to sort of get us there, you have just testified before the break that in Exhibit 50 the current P/E ratio calculation in the illustrative exhibit was done incorrectly; is that your testimony?

A. It was done differently than the way I did it in the prior testimony.

Q. Done differently. And if we look down at the sort of footnote, the symbol footnote there, it states, the current -- this was calculated by using the current price divided by 2005 earnings per share, correct?

A. That's what it says, yes.

Q. Now can I ask you, please, to turn to Exhibit 46, which is your testimony in the last case, and go to page 49 of that exhibit, that would be your SCH-5, page 3, and that's your market price DCF model; do you have that?

A. Yes, Mr. ffitch, I do.

JUDGE RENDAHL: Mr. ffitch, which page are you on?

MR. FFITCH: Page 49 of Exhibit 46, Your Honor, according to our exhibit pagination.

JUDGE RENDAHL: In the upper right-hand corner?

MR. FFITCH: Handwritten number in the upper-right hand corner is also SCH-5, page 3 of 5.

JUDGE RENDAHL: Thank you.

BY MR. FFITCH:

Q. And it's headed non-constant growth market price DCF model, and I will have you look at column 18,

and that's headed average P/E ratio, correct?
A. Yes.
Q. And that's the comparable column to the illustrative exhibit that is marked Exhibit 50, right?
A. Well, I don't think comparable is the right word, but it serves that purpose in the model.
Q. All right.
A. That's the one I'm saying is calculated differently in Mr. Hill's exhibit than I did in mine.
Q. Right, and I'm just exploring that, and let's turn 2 pages onward, page 51 of that same exhibit has the column descriptions, does it not? Are you there?
A. Yes, I'm there.
Q. And if we look at column 18, the description is the average of current and estimated 2000 P/E price earnings ratios from Value Line, correct?
A. I may not have heard you, but it says 2007 P/E.
Q. That's what I intended to say, I don't know if I got it out, but I was just trying to read these words from the exhibit.
A. Right.
Q. And so that explains why you have noted a difference between this calculation and what Mr. Hill has done in the Exhibit 50, right?

A. Exactly.

MR. FFITCH: So, Your Honor, I would like to ask as a record requisition if Mr. Hadaway or Dr. Hadaway or PacifiCorp through Dr. Hadaway could please recalculate Exhibit 50 using the same methodology as Dr. Hadaway used in the last PacifiCorp case, the methodology shown as the column 18 description in Exhibit 46, page 51.

MR. WOOD: I will object to asking the witness to prepare a new study or a new exhibit on a model that he has testified he has found not to be any longer appropriate and doesn't use and that was introduced and calculated by Mr. Hill, it seems inappropriate.

JUDGE RENDAHL: Mr. ffitch.

MR. FFITCH: Well, Your Honor, I think the propriety of all of the DCF analyses are under discussion in the case, and I think it's a legitimate matter for the record to compare the different methodologies that Dr. Hadaway has used in the last PacifiCorp case quite recently with those used in this case. And he has drawn to our attention a difference, an unintended difference in the calculation of this illustrative exhibit, and we're simply offering the opportunity for Dr. Hadaway or PacifiCorp to correct that error and to provide a comparable exhibit which uses the same price earnings ratio methodology.

MR. WOOD: Your Honor, this is not Dr. Hadaway's exhibit, normally witnesses aren't required to prepare other people's exhibits.

JUDGE RENDAHL: Well, I was just going to ask, Mr. ffitch, is Mr. Hill going to be here on February 3rd?

MR. FFITCH: Yes, he will, Your Honor.

JUDGE RENDAHL: And --

MR. FFITCH: And alternatively we could offer to prepare a revised Exhibit 50 using the methodology that Dr. Hadaway has testified to that's in Exhibit 46.

JUDGE RENDAHL: Is it clear to you the difference in the methodology?

MR. FFITCH: Yes, Your Honor.

JUDGE RENDAHL: All right, then I think that would be my preference is to have Mr. Hill revise his exhibit, and if he wishes to substitute the exhibit, then that's acceptable as well.

MR. FFITCH: Thank you, Your Honor.

BY MR. FFITCH:

Q. Now I think we can move on, Dr. Hadaway, we have been discussing differences in your DCF testimony between last case and this case, let's now turn to the risk premium. I think as you testified earlier, essentially your testimony in the case, your primary recommendation relies upon DCF methodology but uses the risk premium as a test of the reasonableness of the DCF; is that a fair summary?

A. Yes.

Q. Now can I ask you to turn, please, to your direct, Exhibit 21-T, and go to page 18, please, and go to lines 15 through 17; do you have that?

A. Yes, I have it.

Q. And there you state:

For the most recent 3 months ended March 2005, Moody's average utility rate was 5.79%, and a single A utility rate was 5.7%.

Correct?

A. Yes.

Q. Now in your risk premium analysis, you use the projected bond yield of 6.7%, which is 100 basis points higher than this current yield at the time you prepared your testimony, correct?

A. That's right.

Q. Would you please turn to Exhibit 25, and that's your Exhibit SCH-5, your risk premium analysis.

A. All right, I have that.

Q. And we can see that looking at the bottom third of the page there's a heading that says indicated cost of equity, right?

A. Yes.

Q. And the first line under that is the projected average utility bond yield, and that's where the 6.7% projected bond yield shows up, right?

A. That's right.

Q. So if you used current bond yields as we have seen of 5.7% rather than the projected yields, your risk premium ROE result would have been 9.95% and not 10.95%, correct?

A. No, not exactly. You noticed that the projected average utility rate is used at the top, I'm sorry, at the top of that lower panel. In other words, the indicated cost of equity begins with that number, and then there's a comparison to what the average interest rate is through the 25 years of the risk premium study, and then there is an adjustment made based on the regression equation that's on the second page that captures the tendency for risk premiums to be wider when interest rates are lower and more narrow when interest rates are high, so you would have to redo it. It turns out when the interest rate goes down by 100 basis points, the ROE goes down by about 58 basis points.

Q. All right. So if we accept that number for purposes of discussion today, then the indicated ROE in the last line would be 58 basis points lower than the 10.95%?

A. Approximately. I'm just saying that you can see in the middle of that lower panel regression coefficient is a negative 42%, and so I'm saying that the drop in the ROE is 58%, the change in the risk premium is a negative 42%. I know that may be kind of confusing, but it's just that interest rates are more volatile than the cost of equity based on the studies that have been done.

Q. All right.

Could you please look back at your previous testimony, that's again Exhibit 46, and if we look at page 53 of that exhibit, that's your risk premium analysis in the previous case.

A. Yes, I have that.

Q. Very similar exhibit. Again, the first line under the indicated cost of equity is the bond yield line, and there the exhibit states, does it not, that you're using a current average utility bond yield?

A. It's actually an average of the three months leading up to doing the case, but I characterize it as current, yes.

Q. All right. It's not projected?

A. It is not a projected number.

Q. Now could you please look at Exhibit 23, Exhibit 23 is your SCH-3 exhibit to your direct.

A. I have that.

Q. Now your projected A rated utility bond yield is based on the S&P economic projections shown on page 3 of this exhibit, is it not?

A. Yes, the top of that exhibit at page 3 says trends and projections, it's one page out of Standard & Poor's Trends and Projections publication.

Q. All right. And your projected bond yield is assumed to be 100 basis points over the long-term treasury bond yield, correct?

A. Yes, that's right.

Q. So if we look in the right-hand column of this exhibit, those are the projections for the second quarter of 2006; is that right?

A. Yes.

Q. And if we look 6 lines up from the bottom, the S&P projections for the 30 year or long-term treasury bond yield is 5.7%?

A. Yes, that's right.

Q. And so you assumed that the A rated utility debt would be 100 basis points above that level, correct?

A. Yes.

Q. Do you provide anywhere in your testimony, Dr. Hadaway, any support that on average utility debt costs have averaged 100 basis points above treasury bonds?

A. I certainly have that data, and I believe we did provide it in response to data requests. We keep a 5 year running tally, and the average spread of single A utility bonds and average utility bonds during 2005 was 109 basis points.

Q. Do you have that anywhere in your testimony or exhibits?

A. I'm sure it's in the data request responses, I believe, Mr. ffitch. I say I'm sure, I believe that it is, because I know we were asked about that. We have started adding to that risk premium exhibit a footnote that explains that that's the way we did it. And then in response to interrogatories -- I think we actually explained that in the rebuttal risk premium analysis if I'm not mistaken.

Yes, if you look at Exhibit SCH-16, which is the same analysis updated to be done November instead of March, we have reduced the single A interest rate to

6.6% from 6.7% because the S&P forecast had gone down 10 basis points over that time period. And at the bottom you see there is a footnote there that says, projected single A utility bond yield is 100 basis points over the projected long-term treasury as shown in Exhibit Number 13, which is the updated version of the S&P Trends and Projections.

And in response to that and actually in response to how did we get the 100 basis over, we provided the 5 year summary of what those spreads have been. I certainly have them, and if for some reason I'm mistaken about their having been provided, I can do it. But my testimony is that the 100 basis points is slightly lower than the 2005 average was, and it's significantly lower than the prior years were.

Q. All right.

Now let's keep looking at that Exhibit 23 for a moment, I've got to find it again myself, that's page 3 of Exhibit 23, again the Trends and Projections page, and if we still look at the March 2005 projection, we see that S&P projected that in the third quarter of 2005 long-term treasury bonds would yield 5.4%; is that right?

A. Yes.

Q. And that was just two quarters away, they were pretty far off, weren't they, Dr. Hadaway?

A. Interest rates, long-term interest rates have not gone up like a lot of people thought that they would.

Q. That wasn't a particularly accurate projection, was it?

A. Neither were the 50 or so that were in Business Week at the beginning of last year. Everyone thought with the Fed increase in short-term interest rates that the long-term rate would go up. It's what Chairman Greenspan described as a conundrum, a flood of money from overseas keeping long-term rates from going up as much as people thought.

Q. Now can you please look at Public Counsel Cross-Exhibit 45, first one in our stack, this is the merchant bond, 1 page merchant bond record excerpt.

A. I have it now, thank you.

Q. All right. And we see there a number of different corporate bond yield averages, right?

A. Yes, that's right.

Q. And public utility bonds are in the third column over; isn't that right?

A. Yes, sort of in a middle panel.

Q. All right. And if you wanted to look at the A rated bonds for public utilities, you would look there under the capital A; is that right?

A. That's right.

Q. Now the most recent three months that are available if we look down at the bottom of the A column that's August, September, and October of 2005, right?

A. Yes.

Q. And what I want to do is, I'm sorry, I'm having trouble reading this small print here at an angle, I just wanted to ask you to agree with an average of the last three months for A rated utility bond yields, and if you look at the last three months in the column there, the average would you accept subject to check is 5.6%?

A. I have calculated it, it is 5.6%.

Q. Okay. Now could you please turn to your rebuttal Exhibit SCH-16, which is Exhibit 36, and if we add the -- do you have that, I'm sorry, page 1?

A. Yes, I do now.

Q. That is your risk premium analysis. If you add that 5.6% number that we have just derived as a current bond yield to your 4.3% risk premium which is shown near the bottom on the right, the equity risk premium, we get a cost of capital estimate of what, Dr. Hadaway?

A. It would be about 10.4%, because again that regression coefficient has to come into play. Remember before we said that there's not a one for one drop in the cost of equity in this model, so if you replace the 6.6% number with a 5.6%, then again you're going to have 100 basis points lower interest rate, so the difference between that and the average interest rate in the study is going to be wider, and you apply the minus 42% regression equation right there below sort of in the middle of that, and that tells you that the ROE would drop by about 58 basis points, because in both your examples we're using 100 basis points lower interest rate.

Q. Okay, so in your exhibit the bottom line is a 10.9% indicated ROE, right?

A. Yes, in this one it is.

Q. And if I look at the 2 numbers immediately above that, 4.3% and 6.6%, those 2 numbers added together add up to 10.9%, correct?

A. That's right.

Q. And your testimony is that if I substitute a bond yield of 5.6% into that column in place of the 6.6% that I can't add that to the 4.3% which would yield 9.9%, would it not?

A. Well --

Q. You're saying --

A. Well, it would except you have to start up at the top, not at the top of the page but at the top of that panel down there, you see, and you have 6.6% you see at the top of the calculations there?

Q. I see that, but I also see two numbers added together at the bottom.

MR. WOOD: Can the witness complete his response, please.

MR. FFITCH: Certainly, I'm sorry.

A. I'm just trying to explain if you, you know, the numbers at the bottom are going to change because the risk premium itself will change. When the interest rate goes down by 100 basis points, the risk premium doesn't go down by that much, it goes down by 42 basis points. So you would have to just go back and rerun the thing.

BY MR. FFITCH:

Q. All right, just a couple more questions. Please turn to Exhibit 51, Dr. Hadaway, and that is your response to Public Counsel Request 177; do you have that?

A. Yes, I do, thank you.

Q. Okay, you refer to FERC decisions in your testimony, and we asked you for a copy, and you provided that to us, and the data request or the exhibit here

includes that, the decision, does it not?
A. Yes, it does.
Q. And this is a FERC or Federal Energy Regulatory Commission ROE decision involving a two-stage DCF; is that right?
A. It's not the same as the two-stage DCF that I or Mr. Rothschild use in this case, but it's a blend of two different growth rates that the FERC uses.
Q. All right. And you use a two-stage DCF in your analysis in this case, right?
A. Yes.
Q. And Mr. Hill challenges your methodology, your two-stage DCF methodology, does he not, especially with respect to the GDP growth rate in that methodology?
A. Yes, he generally challenged the GDP growth rate and applied it both to the constant growth and to the two-stage growth.
Q. All right. And you cited this FERC decision as an example of why your two-stage DCF is acceptable; is that right?
A. I had said in my testimony I believe that the FERC had routinely used factors like GDP growth in their ROE analysis, and the question I believe is, you know, show us where they do that, and so we provided this Williston Basin order, which is one of several where

they have done it.

Q. All right. Isn't it true that this FERC decision in fact uses a methodology like the traditional DCF methodology for growth which you have used earlier but not used in this case?

A. I'm not sure if I understand what you mean by used earlier.

Q. Used in the PacifiCorp 2003 rate case in your testimony.

A. I don't know. Let me make clear what they do. They use a traditional approach just with one growth rate in it. You asked me initially if they used a two-stage growth approach, and they don't in this Williston Basin case. They blend gross domestic product growth rate estimates with analysts' estimates, and then they put that into the traditional DCF model.

MR. FFITCH: All right, those are all my questions, Your Honor.

Thank you, Dr. Hadaway.

JUDGE RENDAHL: Thank you, Mr. ffitch.

Mr. Sanger, are you still on the line?

MR. SANGER: Yes, Your Honor.

JUDGE RENDAHL: And it's my understanding that ICNU is waiving cross for this witness; is that correct?

MR. SANGER: Yes, Your Honor.

JUDGE RENDAHL: Okay, thank you.

Mr. Wood, do you have any redirect for the witness?

MR. WOOD: I have brief redirect, Your Honor.

R E D I R E C T   E X A M I N A T I O N

BY MR. WOOD:

Q. Dr. Hadaway, Mr. ffitch asked you or drew a contrast with your use in your risk premium model of current bond yields in your 2003 testimony and your use of projected bond yields in the current testimony; could you explain why you made that change?

A. Yes, we made that change because interest rates have reached 40 year lows by 2005. In fact, what we saw was that interest rates in March were the lowest they have been since I want to say 1968. They rose a bit, and forecasts were for them to continue rising, the conundrum that Chairman Greenspan mentioned because it didn't happen as quickly as folks thought. And we have continued to track interest rates, and in the rebuttal portion of the testimony we again provided the S&P forecast dampened a bit by their slightly reduced forecasted rates. But those are the kinds of things that we have tried to do and that other commissions have tried to do in the sense that if we look at the last two quarters of 2005, interest rates did go down, they bottomed out in June, they moved up, sort of a ragged upward trend until November, and then since then they flattened out about 10 basis points.

But interest rates today are literally within 3 or 4 basis points of where they were when we prepared this case. In response to the rising interest rate trend that had begun to occur at least up through November, and who knows if it's going to continue but at least the forecasts say that it will, utility commissions provided 10.84% as the average ROE in the third quarter of 2005 and 10.75% in the fourth quarter of 2005, and that's part of my rebuttal exhibit. The more recent fourth quarter data just came out this last week, but that's the trend that we were trying to capture with those rising interest rates in the interest rate forecast.

MR. WOOD: That's all I have, Your Honor.

JUDGE RENDAHL: Mr. Trotter.

MR. TROTTER: Your Honor, if I could have just one clarification question on Exhibit 32, I just want to ask the witness whether those are actual data and not weighted data.

JUDGE RENDAHL: Please go ahead.

R E C R O S S - E X A M I N A T I O N

BY MR. TROTTER:

Q. Exhibit 32 is your schedule 12, excuse me, SCH-12. There may be some confusion on the record about weighting GDP data and so on, but the data you report from 1947 through 2004 are actual data for that year taken from the source you list at the bottom?

A. Yes, the numbers going down the column starting with 1947, yes, they're directly, well, they're calculated directly from the St. Louis Federal Reserve Bank's database. In the spreadsheet that we provided you with this, there are two more tabs behind it that have the inflation raw data and the GDP raw data, and we calculate that column from those.

JUDGE RENDAHL: Mr. Hadaway, are those tabs that you refer to a part of what was filed in the case, or were those given to Staff?

THE WITNESS: I know they were filed in my workpapers with the case, in most jurisdictions that's the way it's done.

JUDGE RENDAHL: All right, workpapers aren't exactly exhibits, I'm just trying to clarify if those tabs that you just referenced are an exhibit in the case or if they were workpapers.

THE WITNESS: No, Your Honor, I'm not sure that they're exhibits at all.

JUDGE RENDAHL: Thank you.

THE WITNESS: But they're part of the electronic file.

BY MR. TROTTER:

Q. So the Federal Reserve Bank on the data you're showing here, they don't make projections, do they, they're just reporting the historical data?

A. They probably do make projections, but that's not what I used. These data are just the raw data.

MR. TROTTER: Okay, thank you, that's all I have.

JUDGE RENDAHL: Mr. ffitch.

MR. FFITCH: Nothing further, thank you, Your Honor.

JUDGE RENDAHL: All right, are there any questions from the Bench?

Chairman Sidran.

CHAIRMAN SIDRAN: Thank you.

E X A M I N A T I O N

BY CHAIRMAN SIDRAN:

Q. Good morning, Mr. Hadaway.

A. Good morning, Mr. Chairman.

Q. As you probably know, we have in a separate

docket pending before us the proposed merger or acquisition of PacifiCorp by MidAmerican Energy Holding Company, and as I understand it, there's been a recent filing by the parties of a settlement agreement that would -- that urges the Commission to approve that acquisition. And my question to start with is, do you think that that has any effect on your analysis, the acquisition or merger of PacifiCorp?
A. Your Honor, in terms of the specific analysis, the reason we use a comparable company approach even when companies themselves have publicly traded data is that it improves the statistical reliability of the estimates to use a sample, and it insulates that particular situation for the company from unique events. So I don't think the MEHC acquisition has any effect whatsoever on the analysis that I would provide just with respect just to the ROE piece of it.
Q. So I wonder if you can explain to me, as I understand your testimony, here I'm referring to Exhibit 21, which is your direct testimony, on page 3, this would be the first paragraph there, in particular starting at line 3 where you talk about your comparable group; do you see that?
A. Yes, sir.
Q. And as I understand it, you have said here:

To be included in my comparable company group, companies were required to have a single A bond rating by either Moody's or Standard & Poor's, to derive at least 70% of revenues from regulated utility sales, have consistent financial records not affected by recent mergers or restructuring, and to have a consistent dividend record as required by the DCF model.

A. Yes, sir, that's accurate.

Q. And, in fact, you excluded as I understand it one of the companies, was it Exelon?

A. Yes, sir.

Q. From the comparable group for the very reason that there had been an announced merger, or at least a merger was apparently under discussion?

A. Yes, sir, between the time we prepared our direct testimony when they were included in the group and we prepared the rebuttal testimony, that had happened.

Q. So doesn't the fact that MEHC had a pending and now on the cusp of finalizing an acquisition of PacifiCorp, doesn't that call into question the comparable group in your analysis since you exclude merger candidates?

A. Well, Mr. Chairman, the reason we do that is to make sure that the price effects of a merger for the publicly traded companies doesn't filter over into the analysis for the regulated activities. And so because PacifiCorp, if they had been part of that group, then we would have had to exclude them and to try to determine from the non-affected companies what the base cost of equity would be without the usual price increase effects that occur around a merger.

Q. Does it make any difference who owns PacifiCorp in terms of the investor expectations?

A. It could, because the rating agencies do look to the parent company, the overall organization, in determining bond ratings. And if MEHC or Berkshire Hathaway were significantly different in terms of bond ratings, then there would be a reason to look at that. But I have looked, and for example the Midwest Energy, not the holding company but the utility operating company, is rated A minus, the same as PacifiCorp is. I know that MEHC is rated lower than that, but Berkshire Hathaway itself has a tremendous amount of equity, $89 Billion or something like that. All this will be much clearer because the Public Utility Holding Company Act will go away in terms of company report, and at the end of this quarter Berkshire Hathaway will consolidate MEHC into its reported financials, and you will be able to see very clearly that it is not a highly leveraged company at all.

Q. One of the challenges in trying to review some of the testimony on cost of capital from all of the witnesses, I'm not singling you out, is there is no discussion of the implications of this acquisition or merger in the analysis, something that as you probably know the Commission raised as a Bench request at the beginning of the hearing for the very reason that we noticed that you exclude merger candidates for the reasons you have mentioned, that there are implications as to who owns PacifiCorp potentially.

A. Well, I may not have explained that, and of course the MEHC thing hadn't come up when I did all this or, you know, really hadn't started to proceed. The idea of having the comparable group is to try to say, if we're looking at just regulated activities and we're trying to say what's the fair cost of capital for the regulated activities, we use that 70% filter for example to keep unregulated activities from dominating the analysis. And if we're trying to say, well, what would the cost of capital be for this company without that merger having occurred, then that's what this tells us.

We don't want the cost of capital to be affected, for example if we use this terminal price model that we debated a little earlier, it would show a very high expected return if you had a company that was expected to go up a lot in price because of a merger. So it's not, what happens is not that the merger affects the utility operations' appropriate cost of capital to fair rate of return, it's that the merger affects the data that we have to use in the models. And so we take those companies that are affected by those kinds of activities out, and the other witnesses did too.

Q. But it does make a difference, doesn't it, who owns the company?

A. Only if the bond rating and the cost of debt and the other factors in the operating companies are some kind of -- somehow affected by the parent.

Q. But we won't know that in this case because we don't have any evidence before us, even though hypothetically one can assume that MEHC will own PacifiCorp, we don't have any information about the potential implications of that?

A. Well, I understand though that you do have I think as you referred to supplemental testimony that will be considered on the 2nd of February, and I think that's where those issues perhaps will be explained.

But from my analysis, if -- I'm doing a Common Wealth Edison case right now that's part of Exelon, and we continue to use a comparable group but with Exelon excluded to estimate Com Ed's regulatory cost of equity. And so it's a complicated and difficult thing, and I know you're all working your way through all this, but from my, just my very narrow perspective on ROE, by using the comparable group method and unless something happened because of the merger that caused all the bond ratings to be a lot lower, then I wouldn't change the analysis one bit.

Q. And does it make any difference to a hypothetical investor that there has been a recent acquisition, especially by a company like MidAmerican and Berkshire Hathaway, in terms of their expectations for PacifiCorp in terms of any future acquisition or merger? Or put differently, does the fact that they have just recently been acquired and the nature of the entity which acquired them have any impact on a hypothetical investor's expectations about, for example, the potential of yet another acquisition or merger of that company?

A. As I sit here I haven't thought about that, that's a good question. I think still the comparable company approach, that might just be another reason why we would want to be sure and leave companies out of the group that are in any way affected by mergers, and that's exactly what we try to do.

Q. Well, obviously the challenge I'm having understanding that reasoning is that PacifiCorp looked at in the real world today would be excluded. If you were doing, for example, one of these other 13 in your example, you would exclude PacifiCorp, would you not?

A. Yes. And as I say, we are right now in the rebuttal phase of a Common Wealth Edison case in Illinois, and we have indeed in our rebuttal update excluded Exelon, and that's the parent company of the subject company. The idea being that to the extent that Exelon's numbers may be affected by a merger, that shouldn't flow over into the regulatory piece of their operations at Com Ed.

Q. Okay. Let me ask you about the Power Cost Recovery Mechanism, I need some clarification about your testimony. And this is again in Exhibit 21 at page 20 at the bottom of the page, and there you're answering a question about how does the company's proposal in this case to implement a power cost adjustment or PCA mechanism affect your analysis; do you see that?

A. Yes, sir, I do.

Q. And you say, it does not change my analysis, and then you go on to elaborate, and first you say that it will bring PacifiCorp in to line with virtually all of the other companies in the comparable group.

A. Yes, sir.

Q. Do you recall just off hand how many of the comparable group had some kind of a PCA mechanism?

A. Yes, sir, all but two, Ameren and Cleco do not to the extent that they operate in Missouri, and I believe Cleco also does not in Illinois. But I must say that in Missouri legislation has been passed now to provide for a fuel adjustment mechanism, and that commission is in the process of developing its rules and so forth in that regard.

Q. Did you look at any of the details of the various mechanisms that these comparable companies have?

A. Not in this particular case. I am not a fuel adjustment clause expert.

Q. But the nature of the details, would you agree, can affect at least the perception of risk in relationship with the companies?

A. Oh, it certainly can. The problem with PacifiCorp is that through the Western Energy Crisis this Commission did the best it could to provide some recovery of the underrecovered costs, but not all of the commissions did the same thing, and in particular in one jurisdiction they didn't recover anything. And since that time, the focus has obviously been more and more on that particular issue, and that's why going forward to the extent that PCA's aren't applied, a risk adder, just as the FERC is doing with some of the transmission cases, will absolutely be appropriate and necessary.

Q. Which caused me some puzzlement, because in the next sentence, in light of what you just said, in the next sentence you say:

While the Commission --

Meaning this Commission.

-- in the past has suggested that implementation of a PCA mechanism should be accompanied by a reduction in the allowed ROE, such a downward adjustment is unwarranted.

A. Yes, sir, I think that is absolutely the way it should be looked at. Again because the comparable group itself is made up of companies that have some form of PCA, and I'm not saying every one of them is 100% automatic collection, but every one of them has some kind of protection except those two that I named for you.

Q. So when you say your analysis would not change, the recommendation you have in terms of the ROE in your testimony, that is premised upon this Commission adopting a PCA or not?

A. It is in a technical sense premised on that. In fact, it is not specifically addressed. It is simply covered by there being the comparable group where all but two companies have PCA's. And, as I said, going forward this has become such a noticed issue and such an issue that investors are concerned about in the bond rating reports and so forth, that to the extent that those things aren't accomplished, this particular group will have to be adjusted or -- and it's not possible to go find samples of companies that's don't have PCA's, so a risk adder will have to be applied.

Q. Well, that clarifies it, thank you.

Does your testimony about the PCA, I don't recall and you can point it to me if I missed it, does that same analysis apply to the decoupling mechanism that's being proposed?

A. We haven't studied the decoupling mechanism at all. In gas cases that I have done we have studied that, and it's like usually fuel recovery mechanisms in the sense that most gas companies have that. I do not know much about the one that PacifiCorp is proposing.

Q. Did you look at the comparable companies in this regard in terms of whether they have a decoupling mechanism or not?

A. I did not, no, sir.

Q. Would a decoupling mechanism reduce risk for the company?

A. We would almost need to go and see, number one, whether it's a material impact on, you know, the way the risk is perceived, and then probably look and see what the status of the other companies is.

Q. So your recommended rate of return here basically did not take into consideration in any way a decoupling mechanism; is that correct?

A. I'm not sure I can go that far. We didn't explicitly go check them like we did the PCA issue, but we did pick very conservatively financed companies with single A bond ratings that are viewed as some of the most conservative companies in the electric utility business. Now to the extent that PCA's and decoupling mechanisms and those kinds of things become more prevalent, if they don't exist already, then I would expect these companies to have them, but I don't know that.

Q. Last question I have is a lot of the testimony this morning related to this argument over how to calculate a long-term discounted cash flow analysis, and what do you think a commission should do in trying to predict the future in terms of the long term if hypothetically one had a company that suggested perhaps a relatively frequent presentation of general rate cases in the next few years? Or put differently, if a company comes forward every year or two with a general rate case, how much weight should we attach to trying to predict infinity?

A. Well, it's not possible obviously to know what investors expect to infinity. But the timing of rate cases doesn't affect the way that that constant growth, just a simple D1 over P0 plus g, g is always the arguing point in every rate case that I have ever been involved in. And what has happened that concerns me, and it concerns a lot of people, is that DCF results just out of the basic model where I demonstrated 9.3%, and other witnesses have demonstrated similar and even lower numbers, have been pushed down by a dramatic change in analyst forecasts. As I said during my cross-examination, typically we argued over whether we should take analysts' growth rates as being too optimistic and average in a little low historical growth to go with that and get down into lower growth rates.

The problem is that growth rates in the 3% to 4% range are very much like inflation. The long-term inflation rate is 3% either from the Ibbotson data going back 75 years or in that 57 year item that I provided was 3.2%. Investors are not going to buy stocks and they're certainly not going to pay multiples of book for those stocks if they expect the growth rate to provide them no real growth whatsoever.

So that's what's happened, and the reasons it's happened is because analysts have become concerned about the rise in utility stock prices and very low inflation rates. All kinds of economists are forecasting things that look about like what's happening right now, we're going to have low inflation forever. Well, we're probably not, but that's what we all as professional economists try to tie back to data that exists. So to use a 2% or 2 1/2% inflation rate instead of a 3% inflation rate pushes things down 1/2% to 1%.

And then you look at the utility industry, and you say, utility stock prices have gone up largely because of consolidation in the industry, anticipation of the Public Utility Holding Company Act going away and things like that, so that analysts just don't think going forward utility shares are going to be as good a value as they were a year or two ago, and they reflect that in lower growth rate expectations.

So all of those things for whatever the reasons are tend to cause just a regular DCF model to give you an extremely low estimate of ROE.

Q. I understood that from your testimony, I guess my point was that it's the old joke about looking for that one-handed economist.

A. That's right.

Q. And it seems to me that the further out one tries to predict the future, the more one longs for the one hand, and the shorter term perspective, the more likely one can count on the one hand being closer to reality. So when you have a prospect of frequent rate cases, wouldn't it be prudent if you were trying to guess what the rate of return was investors expect to take the shorter view?

A. Maybe in some of the data, but the problem is that technically the DCF model doesn't allow you to do that regardless of how many rate cases there are or how close together they are. Any look at that model requires that we estimate g out to the very long-term future. Now you may get another look at it or that you have had to look at it in 2003 and 2004 certainly keeps the changes that you can make maybe easier for, you know, they don't have as much -- certainly not going to have impact to infinity or something like that, but that's not what the model is saying. It's saying that the growth rate that you have to put in there, and it's just to simplify the model, is that that growth rate has to be constant to infinity.

CHAIRMAN SIDRAN: Thank you, that's all I have.

JUDGE RENDAHL: Are there other questions from the Bench?

Commissioner Oshie.

E X A M I N A T I O N

BY COMMISSIONER OSHIE:

Q. Dr. Hadaway, I just want to follow up on a line of questioning that was pursued by Chairman Sidran, and that's with regard to the PCAM. It's my understanding that, and just based on your testimony, that you haven't studied in detail the Power Cost Adjustment Mechanisms that are associated with the companies in your comparable group; did I understand that correctly?

A. Maybe I didn't say that quite right, Commissioner Oshie. What we did was just to take the company's tariffs and the company's 10-K's and go in, and most of them you can read in their segment analysis what they say about the way their fuel cost recovery mechanisms work, they wouldn't all of them describe in great detail whether there is a deadband or not, some of them would. And I certainly read every one of those, so I think I know short of going and doing a survey or interview or something like that how the PCAM's work, but I haven't focused on how one in this state may or may not work. I understand the business about a deadband has been talked about.

Q. Did you in your analysis then of the PCAM's of the comparable companies or the Power Cost Adjustment Mechanisms, did you make any estimate of the magnitude by which the business risk would be reduced by the operation of such a mechanism with regard to those comparable companies?

A. I did it more with respect to looking at the risk that PacifiCorp has experienced. And you have testimony talking about that in any one year the swing in power costs has cost them 350 basis points, 500 basis points on equity, numbers like that. We didn't try to make an explicit adjustment, because what we're really trying to say is how is the risk perception of the company seen by investors, and it's just not quite that precise. If you don't have a PCAM, investors view you as more risky. If you do have one, they view you as less risky. And then the details of it have a lot to do with how ultimately the regulatory process applies those mechanisms.

Q. So if I understand your testimony, you looked more to PacifiCorp, but you didn't analyze the effect of any power cost adjustment mechanism on the business risk of your comparable companies, you didn't analyze it specifically with regard to any individual company and/or as a group?

A. I didn't make dollar calculations for those companies, but I am doing work for two different companies that serve in Missouri right now, and I have looked at the way their lack of power cost recovery mechanism work, just as I have here for these. So I have done the part that has to do with the subject companies, and I have looked to see that, and I am quite familiar with the companies where I come from in Texas that had, when they had integrated utilities there, annual, not annual, but could have them as often as six month true-ups of their fuel cost recoveries, and the commission would have a hearing and decide, if it was all prudent, they would recover all of it. Some states do it that way and some states do it differently.

Q. I believe it was Mr. Widmer's testimony discussed in some detail, I think really carried the burden for the company if you will, or at least that was, you know, their -- it was meant to carry the burden for the company with regard to the business risk associated with their fuel volatility, and I believe he testified there was fuel volatility had increased by 3100%, and how that calculates into basis points off ROE I don't know as you have testified. But I do know from his testimony that his analysis of the fuel volatility risk included the effects of the Western Energy Crisis and the I think it's been referred to as the perfect storm that occurred here in the West with regard to the lowest hydro year on record coupled with what was going on in California and the market manipulation that at least, perhaps I'm not sure if the term allegedly occurred really is pertinent any more, but I think you understand what I'm talking about.

A. Yes, sir, I do.

Q. And we have asked him to do another analysis that would exclude the effects of the Western Energy Crisis, and we were -- I think we're waiting for that result, but I believe his testimony was he thought it would, and I don't think he used any kind of adjective like significantly or greatly affect the result, but he believed that it would affect the result if those extraordinary costs were to be excluded. I want to go back now after that long lead in and ask you I think a rather straightforward question. Do you think that a power cost adjustment mechanism should really be designed to capture variations in normal power costs, or do you think it should be designed to capture extraordinary power cost variations that the company may be exposed to?

A. For most companies it's intended to have the customers pay the cost of that commodity to purchase power. So from my principal experience, it's not intended to be an additional risk that the company can benefit from. If the hydro conditions are very good for example, PacifiCorp might have lower costs, more lower cost power than you thought they were going to have. But in most regulatory jurisdictions, that's not the way it works. The intention is to recover fuel costs from customers, to recover purchase power costs from customers. There are always issues about fixed costs being put into base rates for example, the main charges and things like that and wholesale power contracts, but the idea is that there's not a reason to game the issue of fuel cost recovery in most regulatory jurisdictions.

Q. Well, you know, what it seems like, and this is just, well, this is an honest question, Dr. Hadaway, not that my other questions weren't, but it really strikes me that if, you know, if the company's fixed costs are generally recovered through let's say a decoupling mechanism as an example and their fuel costs are recovered through a power cost adjustment mechanism as a whole, which I understand that's what you're testifying to, where's the risk to the company? Wouldn't it, you know, in other words, wouldn't there be some analysis of risk free investment plus, you know, maybe a couple hundred basis points on top of that and say that's, you know, if there's no fuel risk, if we have taken that out of the equation especially for running in those companies that are primarily thermal based and fixed cost recovery has, you know, been, I don't want to use the term guaranteed, but, you know, somewhat assured by a decoupling mechanism, what's left on the table that the company would be risking recovery of in any of this, you know, in any business circumstance?

A. Well, I'm having the opportunity to do what are Called D companies and T&D companies, distribution only and transmission and distribution, and quite frankly the risks even to those companies, you can ask the companies in California how they felt about it all ten years ago or whenever this all started, but you simply don't typically eliminate the risks that exist in the utility business with these mechanisms.

Most investors, and again I know less about this other than my sort of looking at 10-K's and things for the gas companies, but most investors will look to see what the decoupling mechanism is. In some of the gas companies, even the distribution companies, they have the FERC's straight fixed variable rate design method to try to recover all of their fixed costs through those mechanisms, they have weather normalization mechanisms, they have things that try to move fixed costs away from volume metric recovery.

Now I don't know a thing about PacifiCorp's proposed decoupling mechanism, I haven't seen anything about it in the ratings reports, that's why I was having trouble responding to the Chairman's questions about that, but to the extent that that becomes a trend in the electric utility industry, I feel quite certain that the comparable company, single A rated, 70% regulated activity type companies will give you a fair assessment of what the cost of equity is.

Q. Let's go back, and this is my last question, Dr. Hadaway, it goes back to the question that was asked by Chairman Sidran, and really it's the perhaps fundamentally your choice of the comparable companies because -- and with -- and how that might be affected by the change of ownership. I believe he was, you know, really focused on the fact that if there's a change in ownership and MidAmerican is rated triple B that there has been in the testimony a pretty tight link that had been drawn between the A rating that's now enjoyed by PacifiCorp and its association with its owners, Scottish Power. Now why isn't it that with the change of ownership that that link between the owner and the regulated company would somehow be different with MidAmerican than it was with Scottish Power?

A. Well, MidAmerican is not the ultimate owner, Berkshire Hathaway is, and you can look at that parent company, I have read the Staff testimony about double leverage, it is simply incorrect.

Q. Well, I'm not really concerned about double leverage, I'm just really looking at your choice of comparable companies and how they may be affected by the merger of these two entities. I mean MidAmerican is owned by Berkshire Hathaway, but it still has a triple B rating, and I'm just really exploring why it is that PacifiCorp as a stand-alone company wouldn't also be linked to its parent, MidAmerican and, if you will, for want of another term, suffer the consequences of that link up in terms of its bond ratings?

A. Well, it's just like PacifiCorp has not been linked to I believe it's called PHI, the intermediate holding company, they're linked to Scottish Power, the ultimate owner of the stock of the company. And that same thing, I certainly haven't studied this and I may be getting a little far afield here, but Berkshire Hathaway is not a levered organization. It is at the intermediate holding company because of the way it's structured, may be, I have read Mr. Elgin's testimony about this, but that is not -- nobody is going to make extra money at the parent level. And the risk of the operating company, just like MidAmerican Energy is rated single A minus, there's no reason that PacifiCorp won't be rated single A minus. If it's ring fenced and properly regulated, it simply will not be affected by an intermediate holding company that's not the ultimate owner of the company's shares.

COMMISSIONER OSHIE: Okay, I thank you for your answers, appreciate it.

JUDGE RENDAHL: Commissioner Jones, I understand the Chairman has to go to Cabinet, and so at this point we need to stop, we need to take a break for lunch.

And, I'm sorry, Dr. Hadaway, you will have to hang around until after lunch.

So with that, we will be off the record, and we will come back at 1:30, thank you.

(Luncheon recess taken at 12:10 p.m.)

A F T E R N O O N   S E S S I O N

(1:30 p.m.)

JUDGE MACE: Since Judge Rendahl needs to leave during the course of the afternoon, I'm going to conduct the hearing this afternoon, and I think we need to go back to, Commissioner Jones, I think you had some questions when we left for the noon recess.

E X A M I N A T I O N

BY COMMISSIONER JONES:

Q. Good afternoon, Dr. Hadaway.

A. Good afternoon, Commissioner Jones.

Q. Are you responsible for any of this good weather today?

A. No, Mr. Rothschild is. I tried to claim it, but he kept me off.

Q. We had a wonderful summer meeting in the city of Austin, and I just thought that you brought some of this from Austin to Seattle.

A. We certainly could average out with Seattle for the last couple of months, it would be better off for both of us.

Q. Would you please turn to page 7 of your rebuttal testimony, Exhibit 26-T, page 7.

A. Yes, sir, I have that.

Q. But before we get to that, you referenced as you got into the references here to each of the capital expert witnesses and how their recommendations affect the capital attraction and the credit ratings of each -- of the company, you refer to the Hope and Bluefield Standard, correct?

A. Yes, sir.

Q. Standards. Is there any other standard that you would like us to refer to or think might be relevant for the record such as the Natural Gas Highpoint Opinion or any other decisions of the Supreme Court affecting just, you know, how commissions go about setting just and reasonable rates?

A. There are more detailed discussions in some more recent cases than these, but I typically just use these as the attraction of capital and maintenance and financial standard.

Q. But you're familiar with the natural gas pipeline case and its reference to including consumer interests in determining what is a just and reasonable rate?

A. Certainly. I have not read the decision itself, but I have read comments about it.

Q. I just want to make sure I understand how you ran these, and specifically on Mr. Rothschild's recommendations, how you ran these numbers. As I read this, you took Mr. Rothschild's 8.95% ROE and his 43.5% equity structure recommendation and fed it into your model or your company's modeling of both the income statement and the balance sheet to come up with these three financial metrics; is that correct?

A. That's a very good summary.

Q. And I understand the Staff has already made an inquiry to get your workpapers or the model about how you did this, but can you briefly describe briefly how you run the models and how you, for example, got the free -- the FFO refers to free funds from operation, correct?

A. Yes, sir, funds from operation.

Q. Okay.

A. If we might look at Exhibit SCH-8, I believe that is the sort of backup schedule that supports those things that are in that summary.

Q. Okay.

A. And it's not a very sophisticated model in the sense that utility companies have more sophisticated corporate models, and the rating agency presentations are based on those. But what we found is that a simple model based on the rate base for a given jurisdiction, the rates of return on equity and the cost of debt can then be used to proxy for net income. And then funds from operations would be calculated once you get the net income number by adding back the non-cash kinds of expenses like deferred taxes, depreciation. And then once you have that, it's a matter of simply comparing it to such things as the coverage ratios to interest expense and the percentage of debt as to the amount of debt that's outstanding. But FFO is just funds from operation, and by that, old times it used to be just called cash flow, but it's a little more detailed than that now.

Q. Yeah, what it really is is cash flow, correct?

A. Yes, sir.

Q. And as I understand your conclusions here on the FFO to interest, the FFO to total debt, and the debt capitalization, the only financial metric in which the rating of A minus of PacifiCorp it presently enjoys that is maintained is FFO/interest?

A. Yes, sir.

Q. Correct?

A. That's right.

Q. And the other two financial metrics would in effect be a downgrade, correct?

A. Yes, sir.

Q. Okay. I would like to go back to your direct testimony and talk about the infamous or the famous inverted or the flat yield curve that has been referred to in some testimony today. Page 18, if you would please turn to page 18 of your direct testimony.

A. Yes, sir, I'm there.

Q. When you refer to the inverted or a flat yield curve, what durations of T-bonds or T-bills are you referring to? Are you referring to 6 month on the short end and 30 year on the long end?

A. Either 6 months or 3 months. The short-term treasury bill, either 3 months or 6 months, is about 4.3% right now, and the long-term treasury bond, which they no longer do a 30 year, it's still called that sometimes but it's a little -- the longest durations are a little less than that now, is about 4.55% as of last week, so.

Q. Could you supply for the record, I would be curious to see where each of those rates were during the 2005 calendar year maybe at the end of each quarter, what does your memory tell you, for example at the end of March or specifically in the beginning of May when the company filed its rate case, what was the 2 year rate and what was the 10 year rate?

A. I'm not sure if I remember the 2 year rate, but the 10 year and 30 year rate have been fairly close together. Rates came down until about June and sort of bottomed out in June at about I think the longest bond was more like 4.4% at that time. And then by November they had just ratcheted up, so it would have been a ragged upward trend to about 4.8% on a longer bond. And now they're back at about 4.55%. But I have the data to provide the Federal Reserve System itself, the Washington database as opposed to the Saint Louis database has a very easy place to get those things monthly, and I will be more than happy to provide them if you want them.

COMMISSIONER JONES: Could we make that a Bench request, Judge?

JUDGE MACE: That would be Bench Request Number 29, and I just want to make sure I know what you're asking for, the 10 year?

COMMISSIONER JONES: On the short end which did you refer to, Dr. Hadaway?

THE WITNESS: The 3 month --

COMMISSIONER JONES: The 3 month.

THE WITNESS: -- I think is about the shortest --

COMMISSIONER JONES: All right.

THE WITNESS: But they're all available

there, so it's not hard to get any of them.

COMMISSIONER JONES: Let's do the -- let's do, yeah, let's do the 3 month and the 10 year.

JUDGE MACE: And these are treasury bill rates?

COMMISSIONER JONES: Yes.

JUDGE MACE: And that's for the --

COMMISSIONER JONES: Treasury bill rates during the calendar 2005 year, and let's say at the end of each calendar year quarter, with an adder, what date was the rate case filed on, May 5th?

THE WITNESS: Yes, sir, May 5th.

COMMISSIONER JONES: Let's get the rates for that date as well, please.

BY COMMISSIONER JONES:

Q. What do you think, Dr. Hadaway, are the main reasons for the flat yield curve? I know without -- and you don't need to quote Alan Greenspan on this, he's been widely quoted in the press as saying this is a conundrum, but you have been following treasury bill markets for a long time, there are some arguments that suggest, as you said this morning on the supply side, that foreign investors really had a lot of demand for our treasury bonds at these maturities, but there are also arguments that suggest that perhaps the long-term investor is looking at economic growth slowing and inflation being low over a extended period of time.

A. Well, all those things play together to finally set what the market rates are. The international trade in balance, particularly with China, is discussed very often, as you know. And the Chinese government has to put its money or it chooses to put its money into treasury securities. To the extent that that provides extra money into the whole process, that's one thing that's sometimes noted.

There have also though been discussions about corporations have found themselves with significant cash flow because of the improved economic conditions we have seen for the last at least two years, and so long-term borrowing requirements have been slack while corporate demand for capital and equipment have been slack. In the most recent Business Week discussion of where the economy is likely to be headed, their discussion, and also it's the discussion that goes with that trends and projections, that's actually an eight page document, that summary table is at the back, it's page 8 of that document that just has the statistics, but there is a fair amount of belief that capital spending is very well primed to increase significantly, take up some of the slack, the Business Week discussion in last week's magazine was that this is going to cause people to be surprised who are saying that the economy will slow down in the second half of the year and that unemployment will drop from the present 4.9% rate perhaps to as low as 4.5%, which is lower than it's been in a long time.

Obviously no one knows whether those things will really happen, and the different economists do have different views. Many, most economists are projecting inflation to remain very stable. As I said earlier, some of us are sort of caught on the approach that what has just happened is what's going to happen, and a lot of economic forecasts are that way, and a lot of forecasts that I have tried to do are that way when you look at current.

Q. So back to your -- for good or bad with this rate case we have to project into the future and use our best judgment and rely on experts like you to give our best judgment to what economic growth, inflation, interest rates are going to be, so I specifically want to confirm that you are still standing by your statement on lines 12 and 13 on page 18; can you find that?

A. Yes, sir, I'm here.

Q. Where you say:

Estimates for the next 12 months are for continued economic growth and interest rate increases.

Do you still stand by that statement?

A. Yes, sir. Now that's based exactly on that Standard & Poor's Trends and Projections, the one we had I believe in rebuttal testimony exhibit.

Q. Okay.

A. It's through November. I do have the December version of that, I checked this morning, there is a January version that should be out, it usually comes out on the 20th or whatever of each month. And so those things, the S&P forecast for the second part of 2006 is for the growth rate in real GDP to slow down from the high 3's, almost 4% level down into the low 3's, and that's the slowdown that's referred to. But that's certainly not a recession or, you know, any of that sort of a situation.

Q. So in spite of considerable evidence from the Federal Reserve and from other economic projections that growth is slowing down and perhaps that the flat or inverted yield curve is providing us, you still stand by that statement?

A. Well, I'm saying that the S&P projection for the long bond, the one we were talking about earlier.

Q. Yeah.

A. When we did the rebuttal testimony I believe we had 5.6% as the projected rate, that's the number in the December forecast is 5.4%. In other testimony using this same risk premium approach we have reduced, you know, that rate by 20 basis points.

Q. Understand, let's move on here. Could you turn to page 25 of your testimony, your direct. May I ask you first, Dr. Hadaway, why did you -- why didn't you perform a CAPM analysis for this rate case and relied only on the risk premium analysis?

A. In many regulatory jurisdictions, the CAPM is viewed with considerable concern. FERC will give it no weight whatsoever. For a while that was the case in Texas where I have done most of the work I have done. I did all my graduate work including my dissertation on the Capital Asset Pricing Model. I feel that I know as many of the articles and things that have been written about it as well as I know anything else.

The model is no different than any other, the assumptions obviously determine the results. But the problem with the CAPM is that the risk premium is subject to debate, and people with equal qualifications, probably equal credibility, can find widely varying risk premiums to put into that model. The beta coefficients are subject to debate, whether you use Value Line's adjusted betas or you use Merrill Lynch's raw beta's or someone else can make a significant difference in the results. And even what the risk free rate is, is it a forecasted rate, is it a recent historical rate, is it short-term, long-term, all those things have a tremendous effect.

I have prepared a little exhibit that I have used in some other situations that show that the CAPM based on the raw data from the Ibbotson 2005 book using historical interest rates, recent, you know, current interest rates, and projected out one year interest rates just like I have used in my risk premium produces results between 8.9% and 12.1%. That range is a bit wide for my taste, and people that can support the assumptions that go in to there to me have just as many bases for supporting their assumptions that one does as another.

Q. But wouldn't you agree that some, at least in the economics literature, that some of the same weaknesses of the CAPM approach affect the risk premium approach as well, and that is the premium in effect is very subjective?

A. It is --

Q. One has to first estimate the prospective cost of debt and then estimate the appropriate risk premium to add to the debt. Then you need to use the use of historic risk premiums, which include implicit assumptions about the future, and then you have to choose the term. Now aren't many of those weaknesses also applied to the CAPM?

A. The reason that I like just the bond yield plus risk premium approach is I think it is simpler.

Q. Okay.

A. For example, if you don't like regression, a page of my exhibit that says this is how we have to adjust for lower interest rates and higher interest rates and so forth, you might simply look to 2003 and 2004 and really now 2005 at the risk premium results that are applied by commissions all around the country for all the different utilities that have been decided, and those risk premiums are quite similar to the one that the regression equation says that we should have now with lower interest rates.

But if one wanted to just do a very simple check of reasonableness, which is what I use that model for, one could certainly say, if we believe that on average commissions do, some of them are going to be high and some of them are going to be low, but that the average number that comes out is one representation of a fair rate of return, and we look at the interest rate that exists and subtract it from that, we don't have to do a statistical analysis, we just say it's a 4, about 4 and a quarter, 4.4 risk premium, you add it on to the single A bond rate. The decision of whether you believe interest rates are going up certainly comes into that though.

Q. Well, I'm glad to hear an economist say that something is simple in all of this analysis, thank you.

On page 25 on lines 12 through 15, you state:

The data shows that risk premiums are smaller when interest rates are high and larger when interest rates are low.

And then you quote an economic study by Harris Marston at the bottom. You and Mr. Rothschild seem to have a big disagreement about this inverse relationship between risk premiums and inflation, don't you? Have you had a chance to review his testimony?

A. Yes, sir, I have.

Q. And you still stand strongly by the statement that there is corroborated in the economic evidence an inverse relationship between low inflation, which we currently enjoy and have enjoyed, and a higher risk premium?

A. Well, and Mr. Rothschild can certainly speak to this for himself, but there are different ways of going about it. If one uses an expected real rate of return plus an inflation rate, which is one of the sort of risk premium type models that he does, that's different from what I'm doing. I can't tell you more than just look, if I might suggest, look at the rebuttal risk premium data, we go from 1980 now through 2005, and to me it is apparent that for whatever reason, and that's what I tried to explain in this paragraph that you referred me to, but that back in the early 1980's it's clear that risk premiums were timed. I was testifying for the Texas PUC at that time as a staff witness, and I was criticized because we didn't give returns higher than 16% even though the rate of return on bonds was 14% or 15% at the time. And if you look as interest rates have come down really since 1982 on up until about November of this year, interest rates have come down but equity returns have not come down as much, and that's all the basis that I'm providing.

There are many debates and many different kinds of approaches. Some people say that markets have become safer, that the rates of return of the future are going to be lower than they have ever been before, I don't particularly subscribe to that approach.

Mr. Rothschild quotes a very famous person from Wharton at the University of Pennsylvania who has sold many, many books and is very, very well thought of, but the data that goes to show that going back to the 1800's that the real rate of return from the stock markets are 6 1/2% or 7% are not very good data. Ibbotson people have just tried to update their data to go back to the 1800's, and that data is weak. Stocks prior to the 1900's were more like preferred stocks, the prices didn't change, you got dividends from owning stocks. So there's real question about what we do and, we economists, I guess that's why we're said to have a dark science or whatever they call it.

But the way the risk premium data played out for me is just that the commissions around the country allow what they allow for whatever reasons they allow them, and I have seen risk premium studies based on the S&P 500 change for the risk level of utilities being lower, I have seen it done every different way, but for me this is the most consistent way of going about estimating regulated rates of return. You know, Hope and Bluefield's what are driving us, we're certainly giving the same rates of return as other similarly situated utility companies.

Q. Comparing the risk premium analysis to the DCF analysis, wouldn't you agree that one of the advantages of a DCF analysis is being able to hone down to a company level rather than an industrywide level as

opposed to risk premium?
A. Sometimes that's right.
Q. Sometimes?
A. Some commissions, and this was true earlier when I was at the Texas Commission, you know, a hundred years go or whenever it was, we did do the subject company, but more and more today I see very few commissions taking just one company. I know in the Puget Sound cases that you have had that at times their dividend yields were very, very high, and there were a number of people that, you know, wanted to look at the individual company's rate of return. But in addition to the possibilities of an individual company having other matters going on, there's a question of measurement error, and most economists now use some sort of a comparable group. And I don't think there's a great deal of difference between Mr. Hill's or mine and Mr. Rothschild's, samples are the same, I don't think there's much disagreement on that.
Q. I'm following up on my fellow commissioner's questioning of you this morning, and that is we have an unusual case before us now, we have a merger, a proposed merger before the Commission. There are other mergers going on in the country, Duke-Cinergy, Exelon with PSE, a lot of mergers going on. And you stated it I think to

the opposite the way that I might pose the question, and that is if we have a number of mergers going on in the country, wouldn't the DCF model for the comp -- for comparability purposes pick a peer group of utilities that are actually undergoing a merger or consolidation, look at the impact on the risk profile, et cetera, and run the numbers that way rather than separate out all the non-merging utilities and say, well, theoretically we're going to set this aside with ring fencing, we're going to put it stand-alone and just compare X to these people, couldn't you also make the case that it might be better to -- for -- from a comparability standpoint to look at other utilities either acquiring or being subject to acquisition?

A. The problem with including the merging companies is not that their cost of capital has changed, and I don't think I explained this very well this morning to the Chairman, but it's that the data are skewed. Typically in an acquisition where the stock is outstanding, there's a premium paid, that pushes the stock price up, the dividend yield down. If the company were simply trying to raise capital to build a power plant, that event is not what caused their costs, the power plant and service to utility customers is not what caused the price of the stock to go up, the dividend yield to go down, and thus the low return in the DCF model.

On the other hand, many times companies that are the acquiring companies end up, particularly some of the very, very large consolidations that have occurred, where looking back at the data for the last five years or any period of time you just don't have comparable data to what you have had before, and sometimes because there are arguments that sometimes acquirers have paid too much in acquisitions, sometimes their prices have actually gone down because of the merger, not because of the utility operations.

So that's why we try and what we think about using a comparable company group not affected by merger activity, that's what as a regulator one would want to have to see what the cost of service should be set on.

Q. In your view, has there been any impact on the risk profile, not the risk profile, the attractiveness of utility companies based on the changes to dividend taxation enacted by the recent Congress?

A. We looked at that very, very closely, and during the first several months after the actual change in the law went into place, there were a lot of brokerage houses that had utility company touts that said this is a great new deal. And then we continued to follow month by month by month, and after several months, nine or ten months, those touts ceased to be front burner attention items, and utility stock prices stopped going up and just sort of leveled out and for at least a 12 month period acted about like the Standard & Poor's 500.

With the anticipation of the repeals of the Public Utility Holding Company Act and with whatever reasons there have been though the utilities have done extremely well the past year in terms of their stock prices. The Dow Jones utility average that I was asked about this morning is nearly at the level of about 412 I think or was in the newspaper this morning, that's very near all time record high.

Q. And what would that be roughly in terms of stock appreciation for the calendar year 2005?

A. I don't know, I don't remember for the year, but it was higher than --

Q. 30%, 20%?

A. Something like that.

Q. Something like that.

COMMISSIONER JONES: That's all I have, thank you.

JUDGE MACE: Thank you.

Are there any other questions from the

Commissioners?

Okay, it looks like -- yes, Mr. Trotter.

MR. TROTTER: I just have one clarification.

JUDGE MACE: Go ahead.

R E C R O S S - E X A M I N A T I O N

BY MR. TROTTER:

Q. Commissioner Jones asked you some questions about your Exhibit 28, do you recall that, SCH-8?

A. Yes, I'm with you.

Q. And at the top there it says Washington jurisdictional, do you see that?

A. Yes.

Q. And are those rate base and other financial figures there provided to you by the company based on the Revised Protocol allocation method?

A. They are provided to me by the company.

Q. Based on their rate filing?

A. Yes.

MR. TROTTER: Thank you, that's all I have.

JUDGE MACE: Okay, thank you very much, Dr. Hadaway, I believe you're excused.

THE WITNESS: Thank you, Your Honor.

JUDGE MACE: Let's be off the record for a moment while we switch to the next witness, I believe it's Mr. Williams.

(Discussion off the record.)

(Witness BRUCE N. WILLIAMS was sworn.)

JUDGE MACE: Please be seated.

Mr. Wood.

Whereupon,

BRUCE N. WILLIAMS,

having been first duly sworn, was called as a witness herein and was examined and testified as follows:

D I R E C T   E X A M I N A T I O N

BY MR. WOOD:

Q. Mr. Williams is sponsoring in this proceeding Exhibit 61-T, which is his prefiled direct testimony, and the exhibits thereto, which are numbered 62 through 65. He is also sponsoring Exhibit 66-T, which is his rebuttal testimony, and the exhibits thereto are Exhibits 67 through 70. I should ask you, Mr. Williams, were the exhibits I have identified prepared by you or under your supervision and direction?

A. Yes, they are.

Q. Do you have any changes to make to the exhibits?

A. I have a couple changes to my rebuttal testimony on page 10, line 2.

Q. And for clarification, that would be Exhibit 66-T.

JUDGE MACE: And that's page 10.

A. Page 10, line 2, the number 22 should be changed to the number 21.

Q. Could you wait just a moment, Mr. Williams.

A. Certainly.

Q. I'm turned to the wrong one.

Please proceed.

A. On page 11, lines 18, 20, and 23, the word Hill's should be replaced by Rothschild's so it refers to Mr. Rothschild's rather than Mr. Hill's.

And on that same page, line 20, the number 3 should be changed to number 2.

And on page 12, line 2, the number 3 should also be changed to the number 2.

Those are all the changes I have.

Q. As revised, are these exhibits true and correct to the best of your knowledge?

A. Yes, they are.

MR. WOOD: Your Honor, we also have cross-examination exhibits that have been identified as 38 through 51. I understand that --

JUDGE MACE: I'm sorry, you have

cross-examination exhibits --

MR. WOOD: I'm sorry, wrong numbers, Exhibits 71 through 81, and I understand that one of these exhibits, I believe it is 75 that's Staff has replaced the attachment thereto, they had the wrong attachment and replaced it.

JUDGE MACE: I believe Staff submitted a substitute exhibit for Number 75.

MR. WOOD: Yes. And we would offer Exhibits 61-T through 65, 66-T through 70, and would have no objection to the introduction of cross-examination Exhibits 71 through 81 including the exhibit as modified by Staff.

JUDGE MACE: Are there any objections to the admission of these proposed exhibits?

Hearing no objection, they are admitted.

MR. WOOD: And Mr. Williams is available for cross-examination, Your Honor.

JUDGE MACE: Thank you.

Mr. Trotter.

MR. TROTTER: Thank you.

C R O S S - E X A M I N A T I O N

BY MR. TROTTER:

Q. Good afternoon Mr. Williams.

A. Good afternoon.

Q. I would like to start with your rebuttal Exhibit 66-T, page 8, regarding capital structure, and beginning on line 1 you, it actually starts on the prior page, but you refer to two cases, a PSE case and an Avista case; do you see that?

A. Yes, I do.

Q. And there on lines 6 to 7, you quote from one of those cases where you say it was found that the Commission should establish equity ratios on a forward looking basis as this best reflected where the structure "is most likely to prevail"; do you see that?

A. Yes, I see that on page 8.

Q. And is that a quote from the PSE order that you cite on the top of the page?

A. I believe it is.

Q. Would you accept that the Commission also said that the capital structure it selected "brings us to the right balance between safety and economy"?

A. Well, if that's what the order said, I certainly would agree if that's what it says.

Q. The Avista case that you refer to, that was a settlement, wasn't it?

A. Yes, I believe it was.

Q. And the settlement called for a 40% equity ratio; is that right?

A. Yes, I believe among the other aspects of the settlement, that was part of it.

Q. And that equity ratio was not likely to prevail for the next two years because Avista's actual equity ratio was expected to be lower than that through 2008; is that correct?

A. That's my understanding. I also believe there's some incentives or some penalties if Avista doesn't make sufficient progress in rebuilding its equity capital.

Q. The Commission has used hypothetical capital structures in past rate cases, has it not?

A. I do not know what the practice has been.

Q. Did you examine prior PacifiCorp orders on that issue, whether the Commission has used hypothetical capital structures?

A. I looked at the last order from our last rate case which was a settlement.

Q. I'm talking about litigated rate orders, are you aware of any in which the Commission used a capital structure other than the company's actual capital structure or the one that was "likely to prevail"?

A. The last litigated case I believe for the company was 1987 I believe, I didn't spend a lot of time looking at that order.

Q. On pages 9 through 11 of your rebuttal, you compute financial ratios similar to those that were discussed between Commissioner Jones and Dr. Hadaway; do you see that?

A. Yes, I do.

Q. And the financial ratios you develop on those three pages were based on the company's estimate of Washington allocated results of operations; is that right?

A. Yes, it was based on the rate case that we filed here in front of us.

Q. And so this would reflect application of the Revised Protocol allocation method?

A. I believe that's true.

Q. And then over on page 13 and also on page 15, you include some additional, excuse me, yes, some additional financial statistics, and those are total company, are they not?

A. Yes, page 13 is total company actual results for the 12 months ended September 30th, 2005. Page 15 is also total company actual results for the 12 months ended September 30th, 2005. But page 15 also includes the effect of power purchase agreements, which various parties view as debt-like and adjust the ratios to reflect that, and those adjustments are made on page 15.

Q. And you used information from the company's 10-K's and 10-Q's for that exercise?

A. Yes, the company information came from our public disclosure to the SEC, 10-K's and 10-Q's. The PPA adjustments came from the publications that Standard & Poor's has written about the company.

Q. Turn to page 1 of your rebuttal, 66-T, and the first issue you address is whether or not to include short-term debt in the capital structure; is that right?

A. Yes, beginning on page 1, line 11, yes.

Q. And it's the company's view as you note on line 14 that short-term debt principally funds CWIP and thus should not be a component of the capital structure that finances rate base; is that right?

A. Yes, that's the words that are on lines 14 through 16.

Q. And on the next page 2, paragraph beginning on line 5, you discuss how Pacific accrues AFUDC, and you conclude that that also supports excluding short-term debt from the capital structure; is that right?

A. Right, what I'm saying here on page 2 is the methodology the company uses as prescribed by FERC requires that short-term debt be the first component of capital that's used to calculate AFUDC.

Q. If a company booked AFUDC in its overall cost of capital rather than providing a special allocation to short-term debt, then would you agree that short-term debt should be included in the capital structure?

A. Could you repeat the question, please.

Q. If a utility company booked AFUDC at its overall cost of capital rather than a method that allocates AFUDC based on short-term debt as the first source of capital, under that circumstance would it be appropriate to include short-term debt in the capital structure for rate making?

A. I believe it would, it would avoid the double counted short-term debt that would otherwise incur.

Q. Please turn to Exhibit 79.

A. Could you please identify that for me, I'm not sure I have the numbers that correspond.

Q. It's Staff Data Request 41 response.

JUDGE MACE: I want to note that this is marked confidential.

MR. TROTTER: I don't believe it needs to be, I think we removed that designation.

JUDGE MACE: Thank you.

MR. WOOD: Please let me take a look.

MR. TROTTER: It's redacted on the third

page. I don't believe we ever actually got a clean unredacted copy, and it's not essential, so I think the C can be removed.

BY MR. TROTTER:

Q. Do you have that?

A. Well, I'm not sure I do, could you help me identify and make sure I'm looking at the same one you are.

Q. Well, it's marked Exhibit 79, and it's the company's first supplemental response to UTC Data Request 41.

MR. WOOD: It's about four pages, Mr. Williams, from the back of the Staff witness tab.

A. Yes, I have that.

Q. Okay.

A. Thank you.

Q. The first part A of the request was for you to explain why you did not include short-term debt in the overall cost of capital; do you see that?

A. Yes, I do.

Q. And do you see your response on the bottom half of that, do you see your response to part A?

A. Yes, I do.

Q. You did not include your CWIP or AFUDC discussion in that response, did you?

A. No, the words that are there that speak for themselves.

Q. Is there a reason you did not include your discussion that appears in your rebuttal testimony, you didn't include that discussion in response to Staff DR 41?

A. I think we were trying to be brief in our response and answer the question as directly as we could.

Q. Turn to Exhibit 72, which is your response to Staff DR 323, and go to the second page of the exhibit. Here you show in column A the company's CWIP balance for each month from October 2000 through on the second page, on the last page, excuse me, September '05?

A. Yes.

Q. And am I correct that in the final column, the A minus B column, if the result is negative, then short-term debt exceeded the balance of CWIP for that month?

A. That is correct.

Q. If the total balance of short-term debt exceeds CWIP, then am I correct that at least some of the company's short-term debt is financing some other corporate need than CWIP?

A. I would say that during those months we had

more short-term debt than construction work in process.
Q. Well, was it being used for other corporate purposes?
A. It was being used for something, I can't tell you what it was used for, but the balance is higher than the CWIP balance.
Q. On the last page of the exhibit, am I correct that the last time at least on a month end basis when short-term debt exceeded that CWIP balance was May of '05?
A. Yes.
Q. And the numbers on this exhibit are all month end numbers; is that right?
A. That is correct.
Q. So even in months when the month end balance of short-term debt did not exceed CWIP, short-term debt could very well have exceeded the CWIP balance at some time during that month; is that right?
A. Well, it's just as likely during a month where short-term debt exceeded CWIP that the end of the month might have been different also.
Q. So your answer is yes with that clarification?
A. I think, you know, what we're showing here is month end balances, we weren't asked to do a daily

balance, so it's possible during the month the daily amounts could have been different either direction.

Q. You indicated in your testimony that the company follows FERC rules for accruing AFUDC.

A. Yes.

Q. Is that right?

A. Yes.

Q. Did you review any orders of this Commission directing the company on how it is to accrue AFUDC for Washington intrastate purposes?

A. No, I did not.

Q. Refer you to Exhibits 76 and 77, which are the first is the company's response to Staff DR 20, and the second is your response to Staff DR 292. And beginning with Exhibit 76, part B asked the company to show how the amount of AFUDC was computed showing the capital structure used and the cost of each component, and then in Exhibit 77 we essentially asked for the same thing, a workpaper showing the methodology used to calculate and accrue AFUDC, and the responses appear to provide different information; can you reconcile the differences between these two responses?

A. Well, let me try, let's start with what I show as Staff Data Request 20.

Q. Mm-hm.

A. I think that was 76; is that correct?

Q. Yes.

A. Okay. What's asked for here in A is current AFUDC rates, and then I think the attachment shows on this one page, and this was I think one of five pages that was submitted in the data response, shows you what the rate the company is projecting for the AFUDC rate during calendar year 2005. Now FERC requires us to use one rate for the entire calendar year, so what's going on here is trying to predict what that rate will be per calendar year, and you'll see that's done through a monthly rate in that column that's labeled rate, and it appears for May '05 the rate used was 5.40%, and that's trying to get the average for the year then to that rate at the top box, 5.352%, which is the projected AFUDC rate for calendar year 2005.

Q. Okay, now 77?

A. You will have to help me find that one, what is that one labeled, please?

Q. Staff DR 292.

A. Okay, what's going on here with 292 is showing you the mathematical equation that FERC prescribes to calculate the AFUDC rate.

Q. And according to that formula, the AFUDC rate prescribed by FERC does not reflect just the short-term debt cost, does it?

A. Well, it depends on again your CWIP balance versus your short-term debt. In the case where CWIP exceeds short-term debt, it would be fully funded by the short-term debt, and then the amounts in excess would be calculated by the other components of capital structure.

Q. Turn to Exhibit 71, which is your direct testimony in a certificate of necessity docket in the state of Utah.

A. Right, I believe that's the Currant Creek case.

Q. Yes.

A. Yes.

Q. And is this a correct copy of your testimony?

A. I believe it is.

Q. One of the issues that you testify to on page 2 of the, excuse me, it's page 2 of the exhibit, page 1 of the testimony, is what the company expects the source of funds to be used for construction of Currant Creek; is that right?

A. Yes.

Q. And on line 23 you state:

> The company expects to use a reasonable mix of capital designed to provide a competitive cost of capital, predictable

capital market access, and to allow the
company to remain financially viable.
Do you see that?

A. Yes, I do.

Q. And then on the following lines 2 through 5 on page 3 of the exhibit, you indicate that:

The company will construct Currant Creek
using operating cash flows and the
issuance of new long-term and short-term
debt and if necessary new capital to
fund the construction.
Do you see that?

A. Yes, I do.

Q. Please turn to page 3 of your rebuttal, 66-T, and beginning on line 17 --

MR. WOOD: Could you tell us the page again, please, I'm sorry.

MR. TROTTER: 66-T, page 3, line 17.

MR. WOOD: Thank you.

BY MR. TROTTER:

Q. You're talking about the cost of short-term debt, and then on line 19 you say:

Mr. Rothschild and other witnesses have
utilized a backwards look at the cost of
short-term debt that does not reflect

the steady increase in short-term rates.
Do you see that?
A. Yes, I do.
Q. Isn't it true that Mr. Rothschild indicated in response to a company data request that it was appropriate to use updated short-term debt cost?
A. I'm not familiar with that.
Q. Please turn to page 12 of your rebuttal, beginning on line 5 you make reference to Value Line's forecasted capital structures, and you state that your source for the projected capital structures is Dr. Hadaway's Exhibit 37; is that right?
A. I believe so, I show it as Exhibit SCH-17, but I think that's a numbering convention.
Q. And am I correct that all of the capital structures on Dr. Hadaway's Exhibit 37 are consolidated capital structures for the entire companies and not the capital structure of any specific regulated utility subsidiary?
A. I do not know that, that's Dr. Hadaway's exhibit.
Q. You're referencing it in your testimony, however, are you not?
A. Yes, I am, for purposes of showing comparable capital structure.

Q. Okay. And when you're showing comparable capital structure, are you comparing the consolidated capital structures for the entire companies as opposed to the capital structure of specific regulated utility subsidiaries?

A. Again, I do not know what Dr. Hadaway has included in there. I believe it's, as he mentioned earlier, companies that have more than 70% of their operations are regulated, so it could include some non-regulated activities.

Q. But sitting here right now, you don't know one way or the other whether the capital structures he reports on Exhibit 37 do or do not reflect consolidated capital structures?

A. I'm not certain which one they are.

Q. Turn to page 13, line 5, you indicate the company's, in your opinion:

The company's budgeted capital structure is intended to help maintain its existing long-term debt ratings.

Do you see that?

A. Yes, I do.

Q. And you follow that by saying:

The increase in common equity percentage is necessary to meet the financial targets published by Standard & Poor's.

A. That's correct.

Q. And then on line 19, you show the current A rating guidelines of S&P's 42% to 50% debt; is that right?

A. Yes, for the debt to capitalization ratio.

Q. All right. Turn to Exhibit 73, which is your response to Staff DR 324, and part B of the request asked you to provide the S&P targets prior to the last change in targets; is that right?

A. That's right.

Q. And do you recognize the last page of the exhibit to include the targets that applied before S&P changed the targets?

A. Right, these were the targets they published in 1999.

Q. And if we look down to the last quarter of the chart where it says total debt to total capital.

A. Yes.

Q. Do you agree that prior to the current guidelines, S&P's guideline for an A rating for a company with a business risk profile of 5 was 41 1/2% to 47% total debt?

A. Yes, that's what it says for a company with a business position of 5 for the single A rating category, yes.

Q. And then go back one page to the Standard & Poor's narrative, page 2 of the exhibit, do you see in the third paragraph S&P says:

No rating changes will result from establishing these new financial targets since they were developed by integrating prior utility financial benchmarks in historical industrial mediums.

A. Right.

Q. Turn to Exhibit 74, which is the company's response to Staff DR 313.

A. 313?

Q. Yes.

A. Yes.

Q. And Staff asked for certain financial ratios for the five years ended 2004 and the most recent available time period; is that right?

A. Yes.

Q. And according to this response, PacifiCorp had a debt ratio of between 55.4% to 62.4% between 2001 and --

JUDGE MACE: Counsel, where are you on this document?

MR. TROTTER: The last line.

JUDGE MACE: And this is Exhibit 75?

MR. TROTTER: 74.

JUDGE MACE: I'm sorry, thank you.

BY MR. TROTTER:

Q. Looking at the bottom line, looking at the debt ratio from March of '01 through March of '04, the company had a debt ratio of between 55.4% and 62.4% during that time when the old benchmarks were in effect; is that right?

A. Yeah, there were a number of things going on during that time period, which I would be happy to elaborate on if you're interested.

Q. Well, all of the numbers there were for more debt than specified in the prior S&P benchmarks, isn't that right?

A. Well, you also have to remember during some of this time period we were at business position 3, so if you look at the thresholds for that level, we were much closer to the single A target.

Q. And those targets would have been 47 1/2% to 53%?

A. Yes, so the 55.4% is relatively close to the 53%. You also need to remember during this period we were in the midst of the Western Power Crisis, and the company's financial profile was changing, but we were taking actions to remedy some of those changes, including increased equity contributions coming into the company and forgoing dividends to our parent company for a year.

Q. And when did the profile change from 3 to 5?

A. Well, it originally went from 3 to 4 I believe in 2002 approximately, and then when the new ratios were published in 2004 we became business position 5.

Q. Turn to Exhibit 75 on the third page.

A. I'm sorry, could you help me with the number on that, please.

Q. Response to Staff Data Request 44.

A. Yes.

Q. Turn to page 3, and this is a May 5th, 2005, research summary prepared by Standard & Poor's regarding PacifiCorp?

A. Yes, it is.

Q. And the first paragraph states in part:

The ratings on PacifiCorp reflect an average business profile, a diversified service territory, a reasonably balanced generation portfolio, and recent favorable regulatory treatment in the six western states it serves.

Do you see that?

A. Yes, I do.

Q. Then it says:

PacifiCorp comprises about 45% of ultimate parent Scottish Power's operating profit. A consolidated Scottish Power financial profile has remained adequate for the rating despite the fact that the utility's financial profile was until recently strained by significant amounts of deferred power costs.

Do you see that?

A. Yes, I do, that's what I was referring to earlier.

Q. And then in the third paragraph it says:

PacifiCorp faces near-term challenges to its financial performance that are expected to be compensated by the continued strength of Scottish Power consolidated operations.

Do you see that?

A. Yes, I do.

Q. If Scottish Power no longer owns PacifiCorp, the financial strength of Scottish Power will no longer be relevant to the rating of PacifiCorp; would that be fair to say?

A. That would be one of the considerations that would change that would affect -- you would have to look at who the new owner would be and the other aspects that go into the ratings.

Q. And if the financial strength of the new owner is not as strong as that of Scottish Power, could that influence PacifiCorp's bond rating?

A. Well, I think it depends on if PacifiCorp would be ring fenced and other attributes of a new owner and how that ownership will be structured. I don't think you can necessarily say it would be stronger or weaker, it depends on the specifics of each circumstance.

Q. And the ratings agencies will decide whether or not the ring fencing is adequate to protect PacifiCorp's bond rating one way or the other; is that fair to say?

A. Well, no, I think what they will do, they will determine whether the ring fencing is satisfactory to insulate PacifiCorp from any upstream issues or troubles that might otherwise perhaps affect PacifiCorp's ratings.

Q. Is PacifiCorp ring fenced currently?

A. Not in the traditional ring fencing method that people have talked about. Certainly in the MidAmerican transaction there's ring fencing that's mentioned there, PacifiCorp is not ring fenced like that today.

Q. The next page of the report under outlook says:

A stable outlook reflects consolidated Scottish Power's financial ratios that are adequate for the rating.

Do you see that?

A. Yes, I do.

Q. Is it fair to say then that the consolidated financial ratios are important to the overall bond rating of PacifiCorp today?

A. Under Scottish Power ownership, yes, S&P will determine our ratings in part based on the overall strength of the consolidated group.

Q. Is it correct that an increase in the common equity ratio of PacifiCorp is not necessarily accompanied by an increase in the consolidated common equity ratio?

A. It could be, it might not be as well, it just depends on other things that are going on within the consolidated group.

Q. Let me give you an example. If PacifiCorp's parent borrows money and uses the proceeds of that to make an equity contribution to PacifiCorp, the net effect of that transaction would not result in any increase in the consolidated common equity ratio, would it?

A. No, but I think you have oversimplified it. I mean there's a number of things going on, it's not just one single transaction. Scottish Power itself is a profitable company, it has not paid out all its earnings as dividends, so it's also increasing its retained earnings and building its equity, so if you took this very simplified case, I don't think you can apply that across the board.

MR. TROTTER: Those are all my questions, thank you.

JUDGE MACE: Mr. ffitch, I don't show you as having any cross for this witness.

MR. FFITCH: That's correct, no questions, Your Honor.

JUDGE MACE: Do you have redirect, Mr. Wood?

MR. WOOD: I do.

R E D I R E C T   E X A M I N A T I O N

BY MR. WOOD:

Q. Mr. Williams, you were asked by Mr. Trotter about the financial, about how you calculated the financial ratios that you show in your rebuttal testimony; do you recall those questions?

A. Yes, I do.

Q. And you were asked if those calculations included an assumption that the Commission adopted the Revised Protocol; do you recall that?

A. I do recall that.

Q. Had you assumed otherwise, that the Revised Protocol was not accepted, would the ratios have become better or worse?

A. The ratios would be worse.

Q. You were also asked if the company, questions hypothetically about the company booking for its, in order to avoid double counting of short-term debt on the Staff's proposal, the hypothetical of the company booking its AFUDC rate as well as the funds used during construction rate -- you were asked questions about the company's using its average cost of capital as its allowance for funds used during construction rate rather than the formula that you discussed. Were you to do that, would the company be consistent with the regulations of the Federal Energy Regulatory Commission as to how allowance for funds used during construction are to be computed?

A. No, we would be not following the FERC prescribed guidelines for calculation of AFUDC, we would also not be following the calculations we use in the five other states the company serves, so we would have a disconnect in those.

Q. Would that disconnect in addition -- also cause any difficulties in accounting for this allowance for funds used during construction?

A. I presume it would. We would have to somehow come up with a different AFUDC calculation for Washington assets, not only Situs, but also ones that are allocated as well, so yes, it would.

Q. You were also taken through an exhibit which showed your month-by-month short-term debt as compared to construction work in progress; do you recall that?

A. Yes, I do.

Q. On average, do the exhibits show, which do the exhibits show to be larger, short-term debt or construction work in progress balances?

A. Construction work in process balances.

Q. And you were also asked about testimony about financing of Currant Creek. Regardless of how you finance, does any of that change how your AFUDC rate is calculated?

A. No, again, the following the FERC prescribed AFUDC calculation, the first source of funds which is applied to the CWIP balance determines AFUDC as a short-term debt.

Q. And what is the significance of allowance for funds during construction as far as rate making is concerned?

A. Well, when those assets are completed in a rate base, part of their costs will include not only the direct cost but also the capitalized interest or AFUDC component of the costs while they were under construction. And so by using the short-term debt balance to principally fund CWIP, when those assets enter rate base they enter at a lower cost than if you used a WACC cost for AFUDC, and the customers get the benefit of that lower cost for those assets in a rate base.

JUDGE MACE: When you said WACC?

THE WITNESS: I'm sorry, weighted average cost of capital.

BY MR. WOOD:

Q. You were also asked if you were aware that Mr. Rothschild said it would be appropriate to substitute the current short-term debt cost for those in his testimony, so I would ask you by the way, what are the current short-term debt costs of the company?

A. Sure PacifiCorp issued commercial paper last week, the cost was approximately 4.50%.

Q. Thank you.

You were asked questions from what was identified as Exhibit 73, which was PacifiCorp's response to Data Request Number 324 concerning the targets that -- certain targets established by Standard & Poor's; do you recall that?

A. Yes, I do.

Q. Were the guidelines you were asked about guidelines that currently apply to the company?

A. No. Again, these were the guidelines that were introduced in 1999 which have been superseded by guidelines that came out in 2004.

Q. Are the new guidelines tougher or easier than the ones you were being asked about?

A. The new guidelines are tougher.

Q. You were also asked questions from Staff or from a response concerning your -- the company's debt ratio. I'm trying to find the appropriate response, perhaps you can help me, Mr. Williams.

A. Yeah, I remember which one, I'm looking for it now as well. I believe it was Staff 313 if that's the one you're --

JUDGE MACE: That's Exhibit 74.

Q. 313, yes. Does this debt ratio include short-term debt, the debt ratios you were discussing?

A. Yes, it does.

Q. If it were not, if the short-term debt were deemed not appropriate for inclusion in the capital structure, what direction would those numbers move?

A. The debt to capital percentages would be lower than is shown on this page with the exclusion of short-term debt.

MR. WOOD: I believe those are all the questions I have, Your Honor.

JUDGE MACE: Mr. Trotter, do you have anything else?

R E C R O S S - E X A M I N A T I O N

BY MR. TROTTER:

Q. I just wanted to ask the witness, you were asked by your counsel if you did not use the Revised Protocol to allocate costs to Washington, and you gave a response, what other method would you use if you did not use Revised Protocol?

A. I guess the prior allocation methodology would have been used I would expect.

Q. And what did you assume that was?

A. I'm not certain, I didn't --

Q. Well, you said that they would be worse, so what method did you assume would be used that would make them worse?

A. Well, with the company recovering less costs than its incurring, and the new methodology improves that recovery prospects for the company.

Q. But can you tell me what the prior method was that you would have used absent the Revised Protocol?

A. I can't tell you the name of it, no, sir.

Q. Do you know whether that method was approved by this Commission?

A. Which method?

Q. The method that would have been used if you hadn't used the Revised Protocol, whatever that was.

A. I do not know.

MR. TROTTER: That's all I have, thank you.

JUDGE MACE: Thank you.

I think it's time to hear from the Commissioners, I guess Commissioner Jones, go ahead.

E X A M I N A T I O N

BY COMMISSIONER JONES:

Q. Good afternoon.

A. Good afternoon.

Q. Could you please turn to page 6 of your rebuttal testimony.

A. Certainly.

Q. Page 5 and 6 actually, in which you were asked a question about the stock purchase agreement by and among Scottish Power, Pacific Holdings, and MidAmerican Energy Holdings Company. This gets into the issue of capital infusions from Scottish Power into PacifiCorp. To date, how many actual capital infusions have been made?

A. There have been --

Q. From Scottish Power into PacifiCorp?

A. There have been a total of four, one during 2002, which I don't talk about here, but of the ones that are talked about here, three of them have been made, each for $125 Million, each at the end of the quarters ending June, September, and December, a total of $375 Million then.

Q. And what is the company's position on inclusion of that amount or another amount in the capital structure for this particular test period?

A. My testimony has the inclusion of all four of these infusions in the capital structure.

Q. On what basis do you make that assertion, just refresh my memory?

A. Well, they were required and contractually committed to and had also been in process during the time of this case.

Q. So that's based on a known and measurable --

A. Yes.

Q. -- standard, the fact that --

A. Yes.

Q. -- it's in Section 4.2 of the Stock Purchase Agreement?

A. Yes, and also the fact that the company has received three of the four.

Q. You mentioned somewhere in your testimony that a dividend paid to the parent in this case, would that be a dividend to the parent, do you mean PHI or Scottish Power, was eliminated in 2003? Can you tell me how that decision came about? Who made that decision, was it the Board of Scottish Power, and on what basis did they make that decision, what were the reasons for that?

A. The decision was made I think jointly by the PacifiCorp Board and Scottish Power senior management.

Part of what was driving that again was the attempt to rebuild the company's financial health and financial profile following the power crisis. That was also, as I mentioned earlier, accompanied by a new capital contribution into PacifiCorp of $150 Million during 2002 and then the forgoing of dividends during fiscal year 2003. That was an attempt to try and rebuild and maintain the ratings of PacifiCorp following the effects of the Western Power Crisis.

Q. How many years did has Scottish Power owned PacifiCorp seven, six?

A. Coming up on six now, I believe the acquisition closed in November of 1999.

Q. Was that the only year in which a dividend from PacifiCorp to the parent company was eliminated?

A. Yes, there was also dividend reductions during some of that time period as well. And when dividends were resumed in fiscal year '04, they were at a much lower rate than the company had been paying previously.

Q. Turn to page 3 of your rebuttal testimony, please. This concerns the issue of short-term debt and the rates for short-term debt. If the Commission were to include short-term debt in the capital structure, I understand that your contention is that it should be considerably higher than the 3.32% quoted by Mr. Rothschild; is that correct?

A. Correct.

Q. Based on your previous answer to counsel where you -- I think you said you issued commercial paper last week at the rate of 4.50%, would that be -- if the Commission were to include short-term debt, would that be the most appropriate latest known and measurable rate that we could refer to, or should we look at the 4.79% that you quote as a percentage of or as a LIBOR plus rate?

A. Right, well, there's a little bit of distinction between the two, which I should explain. The 4.69% represents the markets of forward rates, what the market expects LIBOR will be at the end of March, which is the measurement being used for this testimony. The 4.50% I gave you was our most recent issuance cost, and I have information in my testimony, one of the exhibits shows the increase in short-term debt that's occurred over the last year, the increase in short-term debt rates, and there are -- I think the expectation is they will continue to increase. So if the Commission wanted to set -- wanted to include short-term debt in capital structure, I would think it would be most appropriate to use a rate that would coincide with the other measurement dates here, March 31st, and that would be the 4.71%.

Q. I understand, I'm not saying that the Commission will do that, but if we were to do that, I just wanted to get your answer on that point.

You answered counsel on the AFUDC question and asserted that because the capitalized interest is being treated at this lower interest rate than the higher 7% or whatever your longer-term interest rate would be that it actually benefits the rate payers. But isn't it also true that capitalized interest in one sense doesn't benefit the rate payer because you are adding interest on to the actual direct cost of the project, and you're capitalizing interest, and that would be included in the rate base when the Commission would eventually put that into rate base; isn't that correct?

A. That is correct. I guess the question is at what cost would those assets enter rate base, and using the methodology the company has used to date as opposed to the potential alternative where AFUDC is calculated at the WACC or the weighted average cost of capital, those assets would enter service at a higher cost and then would lead to, all things, all other things being equal, a higher revenue requirement then.

Q. My last question concerns debt imputation. Could you turn to page 14 and 15 of your testimony where you talk about this. I just want to clarify that this is, I think we understand what debt imputation is and the impact on the debt calculation effect for PacifiCorp, but is this a calculation that the company carried out on its own, or is this a calculation that Standard & Poor's made based on some meetings or discussions that they have had with you in the recent past?

A. This is a calculation that Standard & Poor's did themselves based on information they requested from the company and we provided to them. And the number that I have here, the $520 Million, not only have they verbally advised us of that, but they have also printed that number, so this should be seen as a calculation by Standard & Poor's.

Q. Does Standard & Poor's currently have any debt imputation on the Mid-Columbia contracts and other long-term PPA's that you have, are they going from zero to $520 Million, or is there an established base of imputed debt already at S&P?

A. To the extent the Mid-Columbia contracts have any capacity or any fixed charge payments, they would be included in that $520 Million. I'm not familiar enough with those contracts to know how they're structured, but the S&P methodology generally says to the extent that any fixed charge, capacity payment, or minimum quantity required, they will view that as a debtlike obligation.

COMMISSIONER JONES: Thank you, that's all I have.

JUDGE MACE: Commissioner Oshie.

COMMISSIONER OSHIE: No questions.

JUDGE MACE: Chairman Sidran.

E X A M I N A T I O N

BY CHAIRMAN SIDRAN:

Q. Good afternoon.

A. Good afternoon.

Q. Perhaps you can clarify one issue for me related to the short-term debt capital structure question. I noticed in your testimony you cited to Avista and Puget prior cases in relationship to I believe the issue was equity ratios. I'm curious, do you know if those companies have short-term debt as part of their capital structure?

A. I believe they do. I talked to some of our regulatory people who I believe had discussions with Avista and Puget regulatory people, and the feedback I got was that they have short-term debt included in their capital structures.

Q. All right. Thanks to Commissioner Oshie who always carries around with him all orders relevant to everybody, he does have an order, and I can represent to you that at least Puget's capital structure has a 3.11% short-term debt as part of its capital structure, I do not know Avista's situation. But assume for the sake of argument that both Puget and Avista have short-term debt.

A. Okay.

Q. As part of their capital structure. What distinguishes PacifiCorp from those two companies as to this issue, why is it different?

A. Well, in some aspects we are, in some aspects perhaps we're not. To me the fundamental issue is avoiding the double count of short-term debt. And if you're including it as the principal source of financing construction work in process, it doesn't seem like the money can also then be financing assets in rate base. The money can only be in one place at one time, and if you're doing both, it seems to me you're double counting. And the benefit of the short-term debt, you know, can only be a benefit one time. I don't see how it can both finance construction work in process as well as assets in rate base.

Q. So you believe -- is it your assumption that that's what's happening with respect to Puget and Avista, they're in effect double counting?

A. I do not know how they calculate their AFUDC, but to the extent that they are including short-term debt as a principal source of the first source of funds that finance CWIP, it would seem to me that they are double counting it both in the AFUDC calculation and in the assets that are providing -- that are in rate base.

Q. Okay. Is there, in your mind would it be a good idea for the Commission to be consistent in terms of how it treats this issue across the companies that we regulate? One way or the other, I'm not suggesting which way this might cut, but I am interested in your views about the potential inconsistency.

A. I guess I would defer to the Commission's judgment. It seems to me you have a lot of issues in front of you and, you know, each of those for each company maybe have some different history and background and, you know, you're in a much better position than I am to I guess give you guidance to how those things should be determined. I think that --

Q. I would agree with you.

A. Thank you, I will stop there then.

Q. I'm sure your counsel is glad you stopped there.

Let me shift gears and ask you what is actually a Bench request, so I don't -- some of this you will not be able to answer as we sit here today. But I assume you are familiar that last week the Securities and Exchange Commission announced its intention to issue a new rule related to disclosure of executive compensation; are you familiar with that press release?

A. I'm familiar that the SEC has, yeah, has adopted new rules for disclosure, but I don't have much detailed knowledge on that.

Q. They haven't actually adopted the rules yet, but they held a press conference and issued a press release in which they announced their intention to adopt new rules and I believe set forth at least in a press release the outline of those rules and asked for comment. And the rationale that the SEC I believe has in proposing these new disclosure rules is their interest in protecting shareholders, the interest of shareholders through full disclosure with regard to executive and, in fact, board of directors compensation. And I believe that our Commission has the same interest with respect to protecting the interests of rate payers, who are of course funding to some degree the compensation for executives and for the board of directors. So my first Bench request is to ask that PacifiCorp provide the Commission with the same information that is being suggested in the SEC's proposed rules, and I will ask Judge Mace for the Bench request number.

JUDGE MACE: Number 30.

Q. That will be Number 30, and it will read, please provide information on executive and director compensation in the same form as described in Section 1 of the SEC's January 17th press release. And I believe we have copies of the press release at the side table here, and we will give written copies of the Bench Request to counsel, but the press release lays out with some specificity the information the SEC intends to require if it goes forward and adopts the rule. But for our purposes, I would like to ask that information be provided.

A. Sure.

Q. The second issue relates to how the company goes about setting executive compensation. Does PacifiCorp retain a consultant to assist the company in setting and adjusting compensation for its senior executives; do you know?

A. I do not know, but I can certainly make sure the appropriate people respond to you on that.

Q. All right. In the event that the company does utilize a consultant in setting compensation for its senior executives, and by senior executives I'm referring to the same level as described in the SEC press release, which I think are the top six if I'm not mistaken highest paid employees starting with the chief executive officer, if there is a consultant's report that's been utilized in the last few years and in particular in the test year, I would like to have a copy of the consultant's report submitted to the Commission. Of course, I will assume that will be confidential. And I guess that will be Bench Request Number 29.

JUDGE MACE: That will be 31 actually.

Q. I'm sorry, 31.

The next request relates to the performance metrics that are used in establishing compensation for the senior executives, do you know if the company uses performance metrics in determining compensation?

A. Yes, I believe it does.

Q. Okay. I would like to have you identify, have the company identify the performance metrics, and provide documentation explaining those metrics, and that would be Number 32.

And then the last, which will be Bench Request Number 33, do you know if the company uses with regard to metrics any measure of metrics that identify benefits to the rate payers from the performance of the company's executives?

A. I believe the metrics include things like safety, customer satisfaction, surveys, things like that. Again, I'm not the most knowledgeable person on this, and I will make sure those who are respond to you, but I believe those metrics are included in the benchmarks that are part of the package.

Q. Thank you, then the same, I make the same request with respect to those metrics, do they exist, and if so, please provide a copy of the metrics and how, related to rate -- to those measures which would be of direct benefit to rate payers and how those are determined.

A. Certainly.

CHAIRMAN SIDRAN: Thank you, that's all I have.

JUDGE MACE: And again, I have copies of those, I will distribute that later on when we take a break.

Yes, Mr. Wood.

MR. WOOD: I had a very brief question.

JUDGE MACE: Go ahead.

R E D I R E C T   E X A M I N A T I O N

BY MR. WOOD:

Q. You were asked, Mr. Williams, about whether it's a good or a bad thing for rate payers for the company to include AFUDC as an addition to its construction work in progress, does the company during the construction period incur actual capital costs, carrying costs?

A. Absolutely, I think that's the purpose of AFUDC is to recognize that there is a cost of those, financing cost of those assets while they're under construction.

Q. And the formula that we talked about from FERC tells how -- which capital sources may be applied to compute that cost?

A. Yeah, it tells what sources and what percentage and then their respective costs.

MR. WOOD: Thank you.

MR. TROTTER: Your Honor, I just had one with regard to the Mid-Columbia contracts that Commissioner Jones asked about.

JUDGE MACE: Go ahead.

R E C R O S S - E X A M I N A T I O N

BY MR. TROTTER:

Q. Mr. Williams, are you aware that the Mid-Columbia contracts PacifiCorp has are take-or-pay contracts?

A. Again, I'm not familiar with the details of those contracts.

Q. If they are take-or-pay, that would imply there's no capacity or minimum payment?

A. I do not know. Again, I don't know the structure of those contracts. I will say that Standard & Poor's in their methodology treats take-or-pay and take-and-pay contracts the same way, they don't distinguish between the two in terms of their calculating debt imputation.

MR. TROTTER: All right, thank you.

JUDGE MACE: Thank you very much, you're excused, and we'll take our 15 minute mid-afternoon recess now.

(Recess taken.)

JUDGE MACE: The next witness is Mr. Rothschild. Mr. Trotter, are you ready to present him?

MR. TROTTER: Yes, I am.

D I R E C T   E X A M I N A T I O N

BY MR. TROTTER:

Q. Would you please state your name for the record.

A. James A. Rothschild.

Q. And what is your position?

A. Financial consultant.

Q. And have you been retained by the Commission to provide testimony in this case?

A. Yes, I have.

JUDGE MACE: Mr. Trotter, I'm sorry, let me interrupt just one moment, I want to swear the witness in.

MR. TROTTER: Oh, I'm sorry, go ahead.

(Witness JAMES A. ROTHSCHILD was sworn.)

THE WITNESS: And what I said already is true as well.

JUDGE MACE: Thank you.

Whereupon,

JAMES A. ROTHSCHILD,

having been first duly sworn, was called as a witness herein and was examined and testified as follows:

D I R E C T   E X A M I N A T I O N

BY MR. TROTTER:

Q. And you are testifying on cost of capital issues in this case?

A. Yes.

Q. And is Exhibit 151-T your direct testimony?

A. Yes.

Q. I believe you had one correction on page 79, so if you could turn to page 79 of that exhibit and identify the correction.

A. Yes, on line 2, the words also and then should be stricken, because the double A reference there is also a form of debt.

Q. So it should read double A rated debt because it is more risky debt?

A. Yes.

Q. With that correction, if I ask you the questions that appear in Exhibit 151-T, would you give the answers that appear there?

A. Yes.

Q. And in the course of that testimony you refer to Exhibits 152 through 163 as your direct testimony and exhibits, are those true and correct to the best of your knowledge?

A. Yes.

MR. TROTTER: I move for the admission of Exhibits 151-T and 152 through 163.

JUDGE MACE: Is there any objection to the admission of those exhibits?

MR. WOOD: I have no objection and at the same time would offer Cross-examination Exhibits 164 through 170.

JUDGE MACE: I will admit Exhibits 151-T through 163.

Are there any objections to the admission of 164 through 170?

MR. TROTTER: Your Honor, my only concern is with Exhibit 170, an excerpt from an Avista order which was a settlement, but I don't know how counsel is going to use it, so I guess I will ask you to reserve ruling on that until I see.

JUDGE MACE: Okay, I will reserve ruling on that but admit Exhibits 164 through 169.

JUDGE MACE: Is the witness tendered for cross-examination?

MR. TROTTER: He is, Your Honor, thank you.

JUDGE MACE: Mr. Wood.

MR. WOOD: Thank you.

C R O S S - E X A M I N A T I O N

BY MR. WOOD:

Q. Mr. Rothschild, I will do my best to keep my questions the best I can simple and short, and we'll hope that we can get out of here at a reasonable time, and so let's start with some questions about capital structure. Turn to pages 13 and 14 of your testimony, that's Exhibit 151-T.

A. Yes, sir.

Q. In the Q&A that starts on line 15 of page 13, you explain I believe that in presenting a capital structure proposal for PacifiCorp you include an amount of short-term debt; is that correct?

A. Yes.

Q. And that's in your case you propose the 4% of the capital be supporting rate base be assumed to be short-term debt?

A. Yes, that's correct.

Q. Okay. Now are you aware of any other of the six states in which Pacific serves in which short-term debt is placed in the capital structure?

A. I have not specifically looked at that, I do not know.

Q. Okay, would you accept subject to check that no other state includes short-term debt in capital structure for PacifiCorp for rate purposes?

MR. TROTTER: Just a clarification, is that currently or ever?

MR. WOOD: Currently. I could ask ever, but it would be too difficult for the witness to check.

JUDGE MACE: One additional thing, Mr. Wood, I know that you want to move along, but you need to remember we are also making a transcript and --

MR. WOOD: I will be --

JUDGE MACE: -- try to speak a little --

MR. WOOD: I will --

JUDGE MACE: -- bit more slowly.

MR. WOOD: I will do that.

BY MR. WOOD:

Q. So would you accept subject to check that no other state currently includes short-term debt in PacifiCorp's capital structure for rate making purposes?

A. My only hesitation is I'm not sure how I can really check that, whether or not the -- how readily available the most recent order on all of the companies would be, but.

Q. Okay. Now let's go into the use of short-term debt briefly. Now the company, would you agree that the company's capital structure in total has to be sufficient to support both plant in service and construction work in progress?

A. Yes.

Q. And construction work in progress at least in this state is plant that is being built but has not yet been placed into rate base; is that correct?

A. Yes.

Q. Now that construction work in progress itself has a carrying cost that we call allowance of funds used during construction; is that correct?

A. Yes, I agree with you.

Q. Now if we turn to Exhibit 165, Cross-examination Exhibit 165, we see you recognize I'm sure the formula of the Federal Energy Regulatory Commission for computing construction allowance for funds used during construction; is that correct?

A. Yes, I have seen it many times before.

Q. And to cut to the chase and hopefully save ourselves a lot of other questions, would you agree that under that formula if the amount, if the construction work in progress balance is equal to or greater than short-term debt, all of the company's short-term debt is assumed to be applied to construction work in progress?

A. For the purposes of that formula, yes, that's correct. But even if one were to do that, you're still left with the question of to what extent is it appropriate for the company to be using short-term debt for its other operations to meet seasonal variations and so forth.

Q. Well, would you agree with the basic principle that a component of capital should only be counted once for the company, that is if it is assumed available to lower the cost of capital for one set of assets, the same capital should not be assumed available to lower the cost of a second set of assets?

A. Well, while that might sound nice, there are some problems with it, and the problems really depend upon your starting point. And by that what I mean is if it's appropriate to conclude that construction work in progress can and is being financed by short-term debt, then what you should expect a well tightly managed company to have is more short-term debt than is sufficient for construction work in progress. Because number one, short-term debt usually is and certainly is right now the cheapest source of capital to the company, so its use should be expanded to the maximum practical limit.

And I'm not suggesting the company could or should have something like 20% short-term debt, that would in most cases be excessive. But what you would -- what you should have is short-term debt available at least to the point where it finances normal seasonal fluctuations that a company incurs. So if you start out by saying it's correct to say that short-term debt is needed and is used for construction work in progress, you're still left with another piece you should expect to see above that.

Q. And do you understand as a factual matter that the average balances of the company in construction work in progress in fact are substantially greater than their average balances of short-term debt?

A. From the interrogatory responses received by the company, most of the time the construction work in progress in recent months that were asked for, most of the time the construction work in progress balance was in excess of short-term debt, but not always.

Q. If upon reflection of what's been testified to as short-term debt is not included as a capital component to support rate base, I would ask you the effects that that would have on capital structure. Turning to Exhibit 151-T, page 4, you contrast, I believe you discuss your recommendation for equity in the company's capital structure and your recommendations of what the capital structure should be, and you recommend I take it that the company be allowed an equity ratio of 43.5%; is that correct?

A. Yes.

Q. You understand that the company is requesting in this case an equity ratio of 49.5%; will you accept that subject to check?

A. Just one second.

Q. Certainly.

A. Yes.

Q. And if one removed the short-term debt, if one were to assume that the short-term debt is, in fact, being fully allocated through AFUDC to construction work in progress, remove that component, would you -- one -- each of the other components would increase by a factor that would be determined by dividing that number by .96, correct?

A. Well, I partially agree with what you said and partially disagree. As I said earlier in response to a question, I don't -- even if you were to conclude that short-term debt was being used to finance CWIP, then you're still left with the question why isn't the company using more short-term debt to finance its seasonal variation. But if for whatever reason one concluded that the company didn't have and shouldn't have for rate making purposes any short-term debt and otherwise wanted to look at its capital structure, then I agree with the mathematical formula you suggested.

Q. And would you agree subject to check that that would raise the common equity ratio to 45.3% in your structure?

A. Subject to check, yes.

Q. And if we look at Exhibit 155, which is your JAR-5, am I correct that we have here your listing of the capital structures of your comparable companies; is that correct?

I'm looking at page 4 of that exhibit.

And I should point out for to avoid confusion, that exhibit was revised 11-16-05.

A. The answer to your question is yes.

Q. I apologize, I'm actually looking at page 2 of JAR-5 that you recently submitted that has your new numbers in them.

JUDGE MACE: Is this the document that says revised 11-16-05 at the top?

MR. WOOD: Yes, it does, Your Honor.

THE WITNESS: Okay, I'm not sure I have in front of me the revised copy.

MR. WOOD: I want to make sure we're not talking past each other, if the witness doesn't have his revised page --

MR. TROTTER: Thank you, Your Honor.

A. I have it now.

BY MR. WOOD:

Q. Oh, thanks, good. And let me find the reference, I apologize, oh, yes, page 18 in this Exhibit 151-T, your testimony, page 18, you state, am I correct that you state lines 7 through 10 that you recommend in looking at this group of companies and determining what an appropriate comparable capital structure is that the median for the group is more telling than the average for the group?

A. In this instance, yes. When you're looking at these two companies that are so far outside of the group, I think the median is a more relevant number.

Q. Okay. And the median if we go back to page 2 of Exhibit JAR-5, I see that the median is the company that you have listed as having a 44.9% equity ratio, that's FPL Group, correct?

A. Well, mechanically they're -- whenever you compute a median, it is the company that has the capital structure that's in the middle of the group, so it ends up being one company, but --

Q. I just asked a factual question.

A. Well --

JUDGE MACE: Again, please don't talk over each other, that's important.

Q. Sorry.

A. The fact that it's any one particular company in and of itself doesn't mean anything. It would always be one company, and that company might or might not be reflective of the group in any other way.

Q. My question I think was narrower. The median company in this particular example is FPL Group?

A. That happens to be the case, yes.

Q. And FPL Group has short-term debt of 7.4%; is that correct?

A. It happens to have short-term debt of 7.4%, but the median for the group is 4.3%.

Q. And would you also, and if you want to do the calculation it would be fine, would you agree subject to check that if we were looking at the permanent capital structure of FPL without short-term debt, their equity ratio would be 48.5%?

A. While that might be true, it distorts the use of the concept of the median to start playing with the numbers that way, but the math is the math.

Q. Okay. 151-T, page 12, look at lines starting at line 7, you say that the 43.5% equity ratio that you recommend is within the 43.1% to 48.8, I'm sorry, the 43.1% to 46.8% range the company has maintained for at least ten years; is that your testimony?

A. Yes.

Q. Okay, let's turn then and examine that for a moment. Would you look -- turn to Exhibit 155, which is again your JAR-5, and here we're looking at what is identified as page 3, which shows PacifiCorp's capital structure; do you see that?

A. Yes.

Q. And that table is the basis for your -- the range you have provided, correct?

A. I believe so, yes.

Q. Okay. Now that table shows both the capital structure with and without short-term debt; is that correct?

A. Yes, it does.

Q. Okay. Is it fair to say that over the past ten years that the, if we exclude short-term debt as supporting the company's plant in service, that the range you cite changes to between 44.3% and 51.1%?

A. The range over the last ten years changes as you have stated, but in more recent years the numbers, more recent years meaning the last four years, the range is still within the range that I cited in my testimony even including short-term debt.

Q. We will get to that. We would agree that as to the ten year range that you cite, the company's requested 49.5% equity is within the range and your

43.5% would in that case not be within the range?

A. My 43.5%, it's -- you -- I don't think it makes any sense, I don't follow you taking a number which is based upon a capital structure that includes short-term debt and comparing it to one that excludes short-term debt. We are comparing apples to highway asphalt or something, I don't know, but they're not the same thing.

Q. My question is a simple one, which is I am asking as to the validity of your recommendation if the Commission determine that short-term debt is not appropriately in a capital structure, in that case your recommendation would be outside of the ten year range?

A. Well, if the Commission for whatever reason chose to exclude short-term debt, then I would not suggest that the Commission test the reasonableness of that or looking at what the company has done by looking at capital structures with short-term debt, they're different.

Q. All right. And let's look at the two periods, the older period and the newer period that you cite and see what we can learn from them. If, for example, we take the years through 2000, that is prior to 2001, looking at the permanent equity, would we agree that the range was 48.6% to 51.1%?

A. Capital structures computed ignoring the existence of short-term debt between the years 1995 and 2000 are within the range you stated.

Q. Now in 2001, as you point out, the equity percentage drops substantially. Now did anything happen in 2001 that might help explain the drop in the equity percentage that you are aware of?

A. Well, I guess 2001 is around the time of the Western Energy Crisis.

Q. That's right. And did the company take a serious earnings hit as a result of that?

A. I would presume it did, yes.

Q. And you have heard testimony that in 2002 the company suspended its dividend?

A. Yes.

Q. And if the company loses money, all other things being equal, unless it infuses new capital, new equity capital, its capital equity ratio will fall, correct?

A. Mechanically, yes.

Q. And you heard testimony that to try to bring the equity ratio back up, equity was in fact infused in 2002?

A. I did hear that testimony, yes, there has been infusion of equity.

Q. And you have also heard that there has been a commitment to infuse $500 Million in equity in 2005 and first quarter 2006?

A. I have heard that testimony.

Q. In effect --

A. The question becomes, of course, which you're leaving out, is what happens economically to the capital structure, what happens to the bond rating, and all of the other things that go along now that we have a track record, which as you have shown you're showing four years, but we have 2005 is now history, so we have in that period as well showing the company maintaining lower common equity ratios.

Q. Do you believe that it would be a matter of significance that the company had announced that it was going to infuse $500 Million, that its parent was going to infuse $500 Million of equity into the company for rating purposes?

A. They are of significance, but we have had a -- the rating has been maintained, and we're not -- we're not talking about a rating that was suddenly changed, the rating has been at A minus for a while and as has -- and the capital structure has been maintained at that level for a while, and there's the other question is you read, for example, which is most clearly and best stated by Standard & Poor's we -- what we see is a focus on capital structure to the consolidated capital structure, and we're not even looking at consolidated ratios here.

Q. So to some extent you would say that the company's low earnings might have been held up and subsidized by its parent?

A. I'm not following your question, the low earnings subsidized, I don't --

Q. No. Are you telling us that you believe that the parent of PacifiCorp has been holding -- has been maintaining the company's -- has been subsidizing the company and maintaining its debt ratings despite substandard earnings?

A. I'm saying that what you should be looking at and what the ratings agency is looking at is the focus on the consolidated entity capital structure, and changes in the capital structure of the subsidiary don't necessarily result in any improvement.

Q. If we look at your -- on -- if we look at your table, is it fair to say that if the company infuses enough equity to bring its equity ratio back to 49.5%, it will have brought itself back about into the mid point of where it was before the energy crisis?

A. Well, you're focusing on excluding short-term debt.

Q. Yes.

A. And the question as you're asking it is just an arithmetic question, is it possible to have internal accounting transactions so that the capital structure as reported excluding short-term debt goes up to a number that was reflective of the period from 1995 to 2000, yes, that's mechanically possible. But I'm looking at what's occurred in more recent times and what's been the regulatory, or excuse me, not the regulatory, what the bond rating reaction to that has been.

Q. Has the bond rating reaction during the post energy crisis period been to lower -- been to change the company's business rating from 3 to 4 and then to 5?

A. I did hear testimony to that earlier today, that the business risk went from 3 to 4 in 2002 and from 4 to 5 I think it was in 2004, and we still have the net result of what the rating agency is doing is leaving the bond rating as it was even though at the same time we have the rating agency demanding -- having -- publishing a more of a tightening of its guidelines for rating. And my experience over the years has been typically what you see for the guidelines tend to be more stringent than is used in practice, not for all companies, but frequently.

Q. Indeed, isn't one of the other things that's happened in the market is that the ratings guidelines have gotten -- have been toughened so that they're tougher than they were in the pre 2001 period?

A. Well, the -- in terms of the percentage of debt, it's the rating agency or Standard & Poor's guidelines, as I just said, are a little bit more stringent than it was, but some of the other factors become easier to meet as the cost of debt has come down, embedded cost of debt comes down, then as the embedded cost of debt goes down, other things being equal, it's easier to achieve stronger ratios.

Q. The ratios have gotten stronger, correct?

A. The ratio guidelines have become a little bit higher. We talked about and heard those numbers were provided specifically contrasting 1999 to the change in I think it was 2002 was the change. When that change occurred, there was a slightly more demanding benchmark, but also during that time what was happening is interest rates were going down, and so even at the more, slightly more difficult benchmark guidelines, they become easier to meet, other things being equal, because interest expense is lower for every dollar of debt the company has.

Q. Is it also correct that during that period the Standard & Poor's began placing imputed debt on companies, including PacifiCorp, for ratings purposes?

A. I'm not sure when Standard & Poor's started the explicit listing of that, I know it's been talked about for a long time. And a concern that I have is if you start going down that path is I've been, and this is -- in proceedings with a lot of companies, and so many companies claim that they have this problem that Standard & Poor's is imputing the debt, but I haven't seen anybody yet present an analysis which says here's a reasonable group of companies that was picked in some fair way and look at what their capital structure is with all the debt imputation. I know when -- and in this proceeding we have the group of companies that was selected by Dr. Hadaway, and we don't know even and the company was unable to determine and I don't know what the amount of imputed debt is for all of those companies. So if we're going to talk about looking at capital structures with imputed debt, let's compare it to standards that have the imputed debt included.

Q. If we are looking for any company as to the amount of equity necessary in the capital structure, is it fair to say that the addition of imputed debt increases the amount of equity needed to maintain any specific ratings metric based on earnings?

A. Well, you have to be careful about what Standard & Poor's is really doing in relation to the benchmarks that it's proposing. When we look at the parameters for PacifiCorp, it would appear that the rating is higher than you would expect to see, but that's been the case for a while, and that's even without making the adjustments for imputed debt. So I think it's fair and reasonable to say what is Standard & Poor's really doing, and if we have been in a situation where whether or not you impute debt if we're looking at capital structure ratios that have existed computed without computing debt and they have been adequate to do the job, then why do we have to change now and impute debt when whether or not it's been done, it's been done all along.

Q. Is it fair to say that one thing Standard & Poor's is aware of is that the company is, in fact, adding $500 Million in new equity?

A. Well, I presume that the company has discussed that but the -- with Standard & Poor's, and Standard & Poor's treats that as it might. But we're not talking about a short-term event. If I were looking at data that had a six month period or a one year period that showed the common equity ratio was -- had dropped and the bond rating had not yet changed, from documents

I have seen from Standard & Poor's, and in fact I believe one was provided to the company in response to a data request, the Standard & Poor's does tend to, although it claims it doesn't fully absolutely do it, in theory it would like to look through a short-term aberration, but we are not looking at a situation here where there has been a short-term aberration. This is, you know, four, five years of reasonable stability in the capital structure, whether you look at it in a consistent manner including short-term debt or a consistent manner excluding short-term debt.

Q. I will just ask you one final question, as we try to imagine what Standard & Poor's may be thinking, is it fair to say that looking at our capital structure that with the addition of the four equity infusions, the company will no longer -- that the company has effectively announced that it is moving back to the pre 2001 equity ratio, average equity ratio?

A. If you're asking me arithmetically whether or not --

Q. Yes.

A. -- that happens, I believe I answered you earlier today, the answer is arithmetically yes. The question is to what extent, if any, has Standard & Poor's factored that in, and to me the evidence is that they haven't, haven't needed to, there hasn't been a change either way in the bond rating.

And the other perhaps even more fundamental question, and to what extent does it matter because they're -- to the extent that equity becomes higher and higher at a subsidiary level, if Standard & Poor's is focusing on the parent, and, of course, we all know the parent is likely to change soon, then is it fair and reasonable for that equity to be there, is it needed, is it something that will produce a lower overall cost of capital in the long run. If it is, everybody wins. And I don't see the evidence that it was, I don't see the evidence that the company has been able to produce that says if we add this more equity, we'll save money. I hear the company saying we have this equity, it will cost more money, and that's contrary to what I thought we were supposed to be doing.

Q. Well, let's turn for a minute to Exhibit 169, which shows the -- this is actually an exhibit of Mr. Hadaway's that shows the Value Line projection of current common equity ratios and projected common equity ratios for the comparable companies. According to Value Line, would you -- do you have any dispute with this table showing that according to Value Line the comparable companies themselves are projected to

increase their equity ratio from 48.6% to 51.8%?
A. 48.6% to 51.8%?
Q. Yes.
A. I have not checked every number in your schedules, but I presume that you have reflected it consistent with the Value Line reports that are attached to that.
Q. And is it fair to say that based on the comparable companies, if PacifiCorp moves to 49.5% equity relative to the comparable companies it will still be playing catch up?
A. Well, I have a lot of problems with this. Number one, this is the Value Line projection, I have seen Value Line projections tend to show increases in common equity ratios that have not -- that frequently have not occurred, so one has to question that and has to question to what extent, how far is it appropriate to forecast within a rate case, especially if a company is going to be in frequently.
And there are other questions as well to the extent that if a company -- I don't think -- while I think it can be helpful to take a look at what other companies in the industry are doing, you have to recognize that this group was chosen because of its A category bond rating, so you're not getting an

appropriate cross section, we're not addressing the question whether triple B would be better than a single A or double A would be better than a single A. So I think we have to be careful how we use an analysis, and we don't want to stretch it beyond its intended purpose.

If a company can show that increasing the common equity ratio lowers the overall cost of capital, why would I be opposed to it, show me. The work that I have done over the years makes me believe that as you go above triple B, it becomes challenging to justify increases in the common equity ratio. And by the way, if you go below triple B, that would generally be a bad idea, that that would increase the cost of capital.

Q. We will come back to that subject in a few minutes. In fact, let's turn to the question of return on common equity and move from capital structures. Let's go to Exhibit 151-T, page 23, if we could.

MR. TROTTER: What page, counsel?

MR. WOOD: I'm sorry, page 23.

BY MR. WOOD:

Q. Looking at line 10, your recommendation for the return on common equity for PacifiCorp is 8.95%, correct?

A. Yes.

Q. Is it also correct that you have been pushing for sub 9% returns on equity for several years now in cases?

A. I don't know when the first time that I recommended a sub 9% cost of equity was. I don't -- I would think that most of the time my recommendations in the last few years have been within the range of 9 to 10, maybe a little over 10 once or twice.

Q. Well, let me ask you, since we met once before, let me ask you about the 2001 Oregon rate case.

A. Yes, I remember that.

Q. And is it correct that in that case back in 2001 you recommended a return on equity for PacifiCorp of 8.9%?

A. Not exactly. Every now and then I get lucky and I anticipate a question, and so I brought a copy of my testimony from that proceeding even though I had to carry it 3,000 miles. And what I said there in my summary of findings and recommendations on page 3 is that the overall cost of capital based upon the 8.9% cost of equity and embedded cost of debt and preferred stock as recommended by Mr. Conway is 7.73%. The 8.9% cost of equity is slightly over the 9% mid point of my --

JUDGE MACE: Mr. Rothschild, can you slow down.

A. I'm sorry.

The 8.9% cost of equity is slightly lower than the 9.0% mid point of my recommended 8.25% to 9.75% range. I have used the 8.90% to be consistent with Mr. Conway's testimony. So what I want to make clear here is that I was comfortable going to a mid point of a range. I mean this -- in that testimony -- in that, excuse me, in that case I was not the only cost of equity witness for the Commission, and so there was Mr. Conway's testimony to consider and give weight to as well. If you look at other testimonies I filed at around the same time, I was going more towards if not at the higher end of the range. So it would have been different if I were the only witness, but like I say, because it was within a range, I felt it was still responsible to do that.

Q. In the --

A. And if you look at the details of the DCF that were filed in Oregon, the numbers were considerably higher then than they are now in this proceeding.

Q. And after considering this, your testimony, since you did have a chance to look at this, do you recall that the Oregon Commission considered your testimony and authorized a 10.75% return on equity?

A. Yes, I remember that they did, and I also looked at the details of that, and the differences were that the Commission looked at my testimony and felt that rather than make -- in that case I essentially used the same methodology as I did here, but then I looked at what Value Line was anticipating for the future return on equity, in other words the value of R, and felt that it was out of line with what investors were expecting, it was considerably higher than the other indicators, and used a lower ROE estimate. As it turned out, I was right. In fact, the actual earnings were the same or lower than I expected. But more to the point, if I mechanically and literally use the Oregon Commission approach, and believe me I didn't do it this way but it happened, it turns out that I'm using a number which is the same as Value Line so that if I use that approach I would end up being much closer to what the commission did.

The one other change the commission made was it didn't like my using a different retention rate than was being forecasted by Value Line. I'm not using Value Line's forecasted retention rate here either, but if you made that change, it would make -- to use the Value Line forecasted retention rate, it would lower my result of the DCF, not increase it. So if you want to go with what Oregon did, I would have to lower my cost of equity recommendation in this proceeding, and I'm not doing that, I mean I'm recommending my approach, not the Oregon Commission.

Q. I don't want to just stick with the Oregon order, as a reality check, would you accept subject to check that within the past year in the Wyoming rate case PacifiCorp was allowed 10.75% return on equity?

A. Well, when you talk about a reality check, I mean --

Q. No, no, just answer, could you answer the question.

MR. TROTTER: Your Honor --

MR. WOOD: The witness is -- if the witness wants to comment, fine, but if I ask a direct question, the witness ought to answer the question.

MR. TROTTER: The question was reality check, and I think it's a very broad opening, the witness ought to be able to respond.

JUDGE MACE: Well, I think, Mr. Rothschild, you need to answer the question first yes or no, and then you can comment.

THE WITNESS: Certainly.

JUDGE MACE: So can we have the question repeated, please.

BY MR. WOOD:

Q. The question was, in the company's most recent Wyoming rate order, was the company allowed a 10.75% equity return?

A. Subject to check I will accept that as yes, but you asked me before whether or not that was a reality check, and that was my problem with the question, I don't -- I think there are much better reality checks out there.

Q. And you would have the same response with respect to a question if the most recent Utah order was for 10.5%?

A. Same answer.

Q. And would you agree that if one looked over all the country in the last six months that the average allowed return for electric utilities has been in excess of 10.75%?

A. When you start talking about averages --

JUDGE MACE: Mr. Rothschild, could I ask you to answer the question yes or no, and then go ahead with your comment.

A. I will accept that subject to check if you provide me the report to check it, I don't have that. But when you look at historic allowed returns on average, I think you have to keep in mind that these days there are, in a typical year, there are a very few rate -- fully litigated rate decisions and they -- so therefore what sounds like it's a broad sampling of what's going on in the U.S., it frequently is not, it could be one, two, or three states that have decisions, and some of those might not even be litigated decisions. Also, what is the range of those decisions, how do capital structures compare, how does the risk compare, so many other things.

Q. Given your concern that it might be one or two cases we're talking about, would you, and I can show you the report, would you accept subject to check we're talking 15 decisions?

A. I can accept subject to check how many decisions it is, you still haven't answered how many regulatory agencies it is and how many of those decisions were litigated rather than settled.

Q. Fine. Let's get a little closer to home, and now we're turning to the exhibit that Staff counsel reserved objections on, and that's Exhibit 170. These are excerpts from the Avista order rendered by this Commission on December 21 of 2005. Do you understand, Mr. Rothschild, that the order we're talking about was what we would call a order on a contested settlement, that is some of the parties settled, others objected on return on equity among other things?

A. Well, let me say what I know is what it says in paragraph 39 of the Exhibit 170 that you provided me, which explains that there was a, well, it says what it says and talks about people talking about it's a negotiated settlement and some -- the voice of opposition. I'm not qualified to categorize this legally.

Q. I just wanted to ask you your comment on three items or findings in this order. If we turn to page 19, finding 41.

MR. TROTTER: Excuse me, Your Honor, I will object to the characterization as a finding, it's just a paragraph number.

MR. WOOD: I'm sorry, paragraph 41, that is correct, it is not a finding.

BY MR. WOOD:

Q. In paragraph 41, do you see the statement summary of Staff's argument, and I just call your attention and I wanted to ask you about the first two sentences, which say:

Staff argues that the 10.4 settlement return on equity "is clearly a reasonable resolution of this issue" because it is halfway between the company's as filed 10.5% and the Public

Counsel's recommendation of 9.25%.

JUDGE MACE: I think you misspoke when you read the first one as 10.5.

Q. I'm sorry, 11.5%, thank you, and Public Counsel's recommendation of 9.25%.

Staff states that 10.4% is within the
range of reasonable returns established
in recent decisions in Washington and
the returns recently granted utilities
in other states.

And my question is, would you concur with that the considerations cited by Staff in this quotation are appropriate matters for the Commission to consider?

A. Consider is a broad, wide opening, and appropriate to consider, yes. In my opinion as an expert on cost of capital, do I think that commissions should compute the cost of equity by taking the average of the two people's recommendations, no, I think that would encourage those people hiring witnesses to seek extremes in both sides rather than seek people who are going to hopefully know what they're talking about and tell the truth.

Q. Well, let me focus then on the second part of that, and I will turn, ask you to turn to page 23, footnote 45, this is an easier question I think by its nature. Footnote 45 of this order says:

We give weight to the average of returns authorized in other jurisdictions as corroborative rather than primary evidence. Such evidence provides a useful check on the reasonableness of any range in cost of equity estimates derived for Avista Corporation.

Would you concur in this conclusion in footnote 45?

A. Well, for the purpose the Commission used this analysis in the context of everything else within the settlement is one thing and I wouldn't -- I think it would be unfair for me to jump in looking at a few pages of an order in a more complex proceeding over which I haven't seen any of the testimony or exhibits or interrogatory responses or briefs or anything else, so I wouldn't want to go there. But if I was asked, do I think the way to determine the cost of equity is to look at the average results elsewhere, I would say no, that would end up in a circular approach that would go nowhere as they -- as capital costs changed, nobody could change.

Q. I will ask you one final question from this order, and this will probably be the easiest one yet, page 22, paragraph 45. This is under commission determination:

Determining the proper cost of capital is an imprecise art. In particular, measuring the cost of equity capital requires the exercise of informed judgment. In contrast to the cost of debt, the cost of equity is not readily observable and must be estimated through use of theoretical financial models and corroborative evidence.

Would you concur in that determination?

A. Yes, but that does not I believe allow -- that does not make it appropriate to use methods that have glaring problems such as a GDP proxy for long-term growth or, for example, taking a risk premium method which computes risk premiums based upon historic actual differences between interest rates at a particular time and the returns earned on equity and then switching to a projection when adding that to a premium that wasn't based on projections. Those are I think beyond what reasonable judgment would allow one to conclude. That's not to say -- and I certainly agree, I can't look up and say the cost of equity is 8.2673% or anything like that level of precision, but I can do things that I know are right, and I can exclude things that I know are wrong.

Q. Well, let's move to something you talked about earlier, let's focus on these ratings metrics and appropriate bond ratings. And I want to start with the so-called Hope test, and Mr. Hadaway quotes the sort of famous words from it, but I will just ask you if you recognize the following standards. Number one, would you agree that under Hope the return to the equity owner should be commensurate with returns on investments in other enterprises having comparable risks?

A. Yes, but one has to be careful. I mean I see that tends to be misused. I have seen a lot of witnesses try and use that to justify a comparable earnings method, and as far as I know, every commission in the country has turned that down.

Q. I believe my question was only, that is the first test, correct? That is the first -- I stated correctly the first test of Hope, correct?

A. That is -- I recognize that, I remember that as a test from Hope, I don't know whether that's the first or the second or whatever.

Q. Okay. You also recall from Hope, and this is what I really want to focus on:

The return moreover should be sufficient to assure confidence in the financial

integrity of the enterprise so as to
maintain its credit and attract capital.

A. Yes, but it also talks about, I don't remember the exact words, but regulation shouldn't fill in for management not doing the appropriate thing.

Q. And you purport I take it in your recommendation to follow both of the standards that I have just cited?

A. Yes.

Q. And would you agree that if we're talking about the capital attractions standard that PacifiCorp has very large upcoming expected capital requirements?

A. There are expected capital requirements of PacifiCorp companywide, I'm not sure how much of that is appropriately related to the service territory in the state.

Q. Have you examined the size of the capital requirement of PacifiCorp?

A. I don't -- I have looked at it, I don't remember what that is off hand, no.

Q. So in talking about whether the company can attract capital, you haven't closely examined what the actual capital requirements are?

A. No, I think the company -- the standard of what it takes for a company to be able to attract capital isn't how much more it needs but whether management is good, whether regulation is responsible, whether the capital structure targets, which is really a subset of whether management is good, are sufficient to maintain a reasonable integrity. And generally from my experience that's, as long as the company is doing what it takes to maintain an investment grade bond rating, which means triple B or better, then it can, with good management, with fair and reasonable regulation, and it then can attract capital. If it's going to be raising capital for assets that are used and useful in rate base and does so in the appropriate mix of debt and equity along with a commission that says yes, we give you a return on used and useful rate base, then the capital will be able to be attracted.

Q. And would you agree that if large amounts of capital would be attracted, the company must maintain its credit ratings, must maintain good credit ratings?

A. I believe as I just said that I would be hard pressed to think of a good example where a company should shoot for something below investment grade. I would like to see investment grade.

Q. I want to focus on your position on this, because I want to make sure it's well understood what your position is with respect to your recommendations, and let's turn to Exhibit 151-T, page 18, line 16, you state that:

The term strong credit rating is a relative term. The issue is whether or not the substantial increase in equity ratio proposed by the company is necessary to either maintain or increase the current bond rating and worth the extra cost.

Even if it did, and I believe this is something you started to talk about earlier, I said we would come back, is it fair to say that you believe it may not be worth the effort or cost to maintain PacifiCorp's current A minus bond rating?

A. I think you should not assume mechanically or automatically that whatever bond rating the company has is the most economical rating. In fact, if you look at it from another way, if a company, and I believe a company should be striving to lower its overall cost of capital in the long run, then it initially defies common sense for the company to have to ask for more money if it's doing something to lower a cost.

Now the words long run, I want to make sure everybody understands what I mean by that, a long run is after the new debt rating is fully reflected in all of the debt that's financed. If, for example, PacifiCorp were to receive a double A bond rating however it got there, other things being equal, when it issued debt it would pay further -- it would pay a lower interest expense than if it had a single A bond rating. But the full reflection of that savings wouldn't occur until all of the debt retiring was refinanced, and so that's what I mean by the long run.

And conversely if the company were to have its bond rating lowered to triple B, of course it would take a while before all of the debt rolled over and had a higher interest cost. But if a triple B debt rating with its higher interest cost saved money because it used less equity, it might be justified. And I can say from the work I have done, not that it's in my testimony in this proceeding, that if you get to double B, the cost of debt and the cost of equity goes up so much that it doesn't save money, it costs money.

Q. And then is it fair to say that in looking at what we refer to as the second half of the Hope test, with your equity return retirement you really weren't concerned with whether your recommendation maintained the -- would maintain the current A minus rating of the company?

A. Well, it's not maintain the A minus rating, it's maintain the reasonable credit worthiness of the company. And if you allow the company an opportunity to earn its fair cost of capital and allow the company an opportunity to minimize its cost of capital and do it correctly, recognizing that double B debt for example costs a lot more than, frequently, depending on the capital markets at the time, can and often does cost a lot more than triple B, and the cost of equity tends to go up a lot then also, that I am by looking at and looking towards a capital structure and suggestion to the company, who indeed has the burden of proof on this, should prove its -- economically prove its need to change the capital structure, then I'm fully consistent with the Hope and Bluefield Standards.

Q. Is that a long answer that translates into no, you weren't concerned about whether your recommendation maintained the A minus rating?

A. No, I think there was a -- the A minus -- you're putting A minus in my mouth. I'm not -- what I'm looking at here by the way, I'm not saying -- I don't believe my recommendation would change the bond rating because it's consistent with the capital structure the company has been successfully maintaining, been able to maintain in achieving that rating. So in that way, that particular issue is covered. Now whether or not the bond rating would be maintained if and when the merger goes through is another issue.

Q. I will ask the question one more time, because I believe --

MR. TROTTER: Your Honor, I'm sorry, I'm going to object to the conversation, if we could just have questions, but we're getting a lot of discussion that's not a question, so I'm going to object to the discussion that's not a question from counsel.

MR. WOOD: Your Honor, that's fine, I'm having difficulty getting a yes or no question answered.

BY MR. WOOD:

Q. And my question is, in making your equity return recommendation, is it fair to say you were not concerned with whether or not adoption of your recommendation would be consistent with maintaining PacifiCorp's A minus rating?

JUDGE MACE: Mr. Rothschild, if you can answer this yes or no, I need to have you do that.

A. There's several parts in there, and so I really don't know how to answer it simply, I don't know how to do that. I don't know how to answer to give an accurate reflection of what I'm saying in a way that is simpler than I just did. What I'm trying to say is my recommendation is consistent with maintaining the A minus bond rating, although it's possible that other factors such as the pending merger might change it. But I wouldn't necessarily say that it's the responsibility of the Commission to maintain a bond rating at whatever it is. I do think it is the responsibility of the Commission to be mindful of the need of a company to raise capital in reasonable terms certainly, and that's very much in the best interest of rate payers and the company to be able to raise capital when needed.

Q. Do you see any risk if PacifiCorp were pushed down to the triple B level, any risk other than a potential increase in the cost of debt, do you see any other risk that the company might incur and its customers?

A. Well, certainly any time the debt rating goes down, there is a time in more and more extreme debt markets where a company could have a more difficult time financing. Triple B is an investment grade rating, there are many utility companies that have successfully -- successfully have and have had triple B ratings for a long time. A lot of companies that argue against the triple B rating point to a very extreme capital market that occurred for a few months in I want to say 1974, I'm not sure if I have the year right, but there was a short time period where triple B long-term financing was not available. But that was a matter of months, and there were other bridge financing that was possible.

And the question then becomes how much more should rate payers pay, and how much more is it appropriate for a company to design for an event which is rare and manageable. So I don't -- I wouldn't reject triple B out of hand, and I'm not recommending triple B as a target, a single A target can be reasonable also. But in order for the company to justify increasing its common equity ratio above the level that was necessary, was sufficient to maintain the current bond rating, I think is something that shouldn't be treated lightly. I think if the company can prove it, that it's going to save money, and this is the cost of doing it, and this is what we get for it, the cost being the higher cost of the equity component but what we save is a lower cost of equity and a lower cost of debt and that can be justified, I'm all for it, but prove it.

Q. Do you foresee a risk for a company if you push their metrics downward of getting into a situation like Avista has gotten itself into?

A. I'm not sure what the specifics of the Avista situation are, so if you want to elaborate on that, I could comment.

Q. Do you think it's reasonable for a company to want to maintain a reasonably good distance between itself and a non-investment grade rating?

A. I think it is a good idea for a company to target a bond rating higher than -- sufficiently high so that it maintains the investment grade.

Q. If we turn to 151-T, page 11, you say I believe a couple of things about the ratings metrics, and I have just a couple of quick questions. In talking about PacifiCorp's debt ratio in the question -- in the answer that begins on line 8, you cite PacifiCorp's debt ratio and compare it to medians for A and triple B companies; do you see this?

A. Yes.

Q. Is it fair to say that the debt ratio you have cited does not include the $520 Million in S&P imputed debt?

A. None of those numbers do.

Q. Thank you.

Then on page 12, lines 7 and 8, I'm sorry, lines 1 and 2, you discuss the company's coverage ratio of 2.95% and compare it with triple B rated companies and A rated companies, and would you agree on its face the 2.95% from your recommendation is below the median for A rated companies?

A. The 2.95%, which is the coverage ratio that would result from the implementation of my recommendation, not necessarily what the company's coverage ratio is, I just want to make sure it's described as what it's intended to be, is significantly above the median for triple B and below the median for single A. Obviously 2.95% is less than 3.2%, but it's higher than 2.3%.

Q.   All right.

A.   And that's somewhere around the A minus where we are.

Q.   The very last questions that I wanted to ask you relate to what it means to expect to earn any given equity return. Is the equity return in your understanding the number that the company should, properly managed, reasonably expect to be able to earn, realizing it could do better or worse?

A.   My recommendation is what I would -- what should be what the company is provided an opportunity to earn on its used and useful rate base.

Q.   And would you agree that if a commission set an equity return but allocated -- but accepted an allocation of rate base among states that did not allow all of the rate base to be included or to receive a return, that all things being equal, the company wouldn't expect to earn its allowed return?

A. Well, I think you're -- I will answer the question first, which is if for whatever reason a company has items of rate base that go unreimbursed, unallowed, other things being equal, then the company would earn less than its authorized return. But what I'm talking about and what I think at least from what I have always been told is any one particular commission has a responsibility to see to it that its regulated company earns a fair and reasonable return, and if a related subset of that company in another jurisdiction is overearning, then it would be inappropriate to have that overearning be counted in reducing the return, and the converse would be true also.

Q. Would you also, would you agree that if for any reason the Commission were to take the short-term debt components of the company and count it twice that all things being equal the company over time could not expect to earn its allowed return?

A. I would, as is most of the -- most of the time there have been exceptions to that, but virtually all the time short-term debt is the cheapest source of capital. If the amount of short-term debt in the capital structure were overstated for an inappropriate reason, then that would be an inappropriate disallowance. But if the reason were that management was using less debt than it could or should or that the Commission -- and I have certainly heard -- I know where you're going, no secret to anybody, talking about the AFUDC and how that's treated -- if the -- if this Commission felt that it wanted to include short-term debt in the capital structure and instruct the company to use the weighted average cost of capital for AFUDC, that's not a shortfall and that's not a double count. All that is is a timing issue that recognizes, as is the standard issue with construction work in progress and many of us have heard it many times before, it's about which rate payer pays for the construction, those that happen to be rate payers during the time the construction is occurring or those that happen to be rate payers after the plant goes into service and is used and useful to them.

Q. And the alternative you're suggesting here would mean that Washington, for example, would have an AFUDC rate that differed from that in FERC accounting, correct?

A. That could be the case, yes.

Q. And would differ from the AFUDC rate applied to the portion of plants allocated to each of the other five states in which the company operates?

A. That might be true, or it might be true that the Commission says that if the company wants -- is really using short-term debt for construction work in progress, okay, but then it should be expected to have additional short-term debt to fund its ups and downs throughout the year to serve the winter peak, to serve the smaller summer peak, and other seasonal variations that are -- that normally occur.

Q. Are you recommending that the Commission make orders telling PacifiCorp how much short-term debt it should be issuing?

A. I'm recommending that the appropriate way to look at capital structure is to look at what is reasonable for good management to be able to implement, and if there is a source of capital that's available that's cheaper than other sources and can be used in a reasonable level, then I think it's fair to consider that. And the reason, as I said earlier, 20% debt, short-term debt, is not reasonable, that would be way too high.

Q. Are you -- do you by any chance know when the last year was that the company earned its allowed rate of return in Washington?

A. I have not looked at those numbers, no.

MR. WOOD: Thank you, I have no other questions.

JUDGE MACE: Redirect, Mr. Trotter?

MR. TROTTER: I do.

R E D I R E C T   E X A M I N A T I O N

BY MR. TROTTER:

Q. Mr. Rothschild, you indicated that your rate of return should be applied to the property that's used and useful for service?

A. Yes.

Q. And do you think it's fair for this Commission to require the company to show that the plant that it wishes to earn a return on in this state is used and useful for service in this state?

A. Certainly.

Q. Turn to page 18 of your testimony. Counsel asked, I think he quoted lines 16 through the first part of 19, and the last phrase on line 19 he didn't quote, but that says the company has not made either showing; do you see that?

A. Yes.

Q. And is that your testimony?

A. Yes.

Q. Did you proceed on the basis that the company needs to prove that the capital structure it seeks for rate making purposes is safe and economical?

A. Yes.

Q. Did the company make that showing?

A. No.

Q. You were asked some questions about Wyoming ROE, did you look at the record in that case?

A. No.

Q. Has the company provided that record to this Commission?

A. Not to my --

Q. To your knowledge?

A. Not to my knowledge.

Q. You said there are much better reality checks, and we heard some from Dr. Hadaway today on some recent publications, are you aware of some reality checks the Commission should consider?

A. Yes, I am. There's one reality check that comes up and it's a -- I think it's a very readable form, and I'm referring specifically to an article in a Fortune magazine that my copy says display until March 20, 2006, it's a Fortune Investors Guide 2006. And what's particularly interesting is that the article, an article which starts on page 64, is all about Professor Roger Ibbotson, who is a gentleman who Dr. Hadaway referred to numerous times earlier today, and the name of the -- the title of the article is 9% Forever, question mark. And it goes on to explain that Dr. Ibbotson's work says that an investor in the stock market in his opinion will earn 9.27%, which he derives from a combination of a dividend yield of 4.23%, an earnings growth of 2.03%, and inflation forecasts of 2.72%.

And, of course, this is all -- while on the one hand this is one person's opinion, even though it's one that is a person who is often quoted in rate proceedings and relied upon in part by Dr. Hadaway, we also have here, which I find very interesting, is the debate. There are other people in here that actually severely criticize Dr. Ibbotson, but they criticize him for being too high. I don't see any criticisms in this article, there aren't any criticisms in this article for him being too low. And the other thing is, well, it's 9.27%, gee, that's a little bit higher than I'm recommending, but the 9.27% is average for the stock market, it's not for a lower risk utility, electric utility. So it doesn't take much to see that my 8.95% recommendation being only a little lower than Dr. Ibbotson's criticized for being too high number makes my number very, very credible, if not conservatively high.

Q. With respect to the use of short-term debt to construct -- for construction work in progress, is the company limited to short-term debt, or can it use internally generated funds to fund construction?

A. Oh, it certainly can use internally generated funds, yes.

Q. And what are the principal sources of internally generated funds?

A. Depreciation cash flow, deferred tax cash flow, and earnings.

Q. And are those trivial amounts, or are those substantial amounts?

A. Oh, they're usually for regular electric utilities are substantial amounts in most cases.

Q. In your opinion, should a perfect utility have a layer of short-term debt in its capital structure for rate making even if FERC assumes it uses short-term funds to fund CWIP?

A. Yes. The normal operations in addition -- other than CWIP have seasonal variations and other short-term needs that occur, and so companies prudently use a reasonable amount of short-term debt. It might be a period in the year where the short-term -- time periods in the year where there's no short-term debt and other times when it's quite large.

MR. TROTTER: Those are all my questions, thank you very much.

JUDGE MACE: Anything further, Mr. Wood?

MR. WOOD: Just very briefly.

R E C R O S S - E X A M I N A T I O N

BY MR. WOOD:

Q. I take it your last statement about use of short-term debt for variations during the year, in other words are you talking about using short-term debt for working capital?

A. Short-term debt does finance items that would often be categorized as working capital, yes.

Q. Is that what you mean when you talk about financing fluctuations throughout the year?

A. Much of it might come under the category of working capital, perhaps some items might not depending. Some commissions define working capital differently.

Q. Are you aware that the Commission Staff has testified that the company has no working capital needs in Washington?

MR. TROTTER: I will object to the question, the testimony was it has no working capital needs, net working capital needs supplied by investors.

Q. That is correct, are you aware of that?

A. Yes, I am aware of that, but it does not change the fact that the company can and does use short-term debt to finance the fluctuations. If the fluctuations occur on a negative range overall, it's still fluctuations, it's just -- in other words, if you have an average amount of negative short-term debt, it's kind of like a baseload plant, if you will. It's just if you have a baseload amount of available funds from rate payers, but the amount is greater in some periods of the year than others, then you still can and should fill in the gap with short-term debt. It just defines what level you're starting at, you still have the sign curve.

MR. WOOD: No further.

JUDGE MACE: Questions from the Bench.

E X A M I N A T I O N

BY COMMISSIONER OSHIE:

Q. I guess I will start off, Mr. Rothschild. My name is Commissioner Oshie, and I just -- I really want to focus in very briefly on your recommendation here in this case of 8.95% for the cost of equity for the company. And it's been raised at least a few times, perhaps not entirely within your cross-examination but the cross-examination of others, that this Commission as recently as February of 2005 authorized a 10.3% rate of return on equity for Puget Sound Energy, and in a matter that was resolved in December of 2005 with Avista Utilities we approved a settlement that was contested, and contested as to the issue of the rate of return of 10.4% for Avista Utilities doing business in the State of Washington. My question to you is, what's different about PacifiCorp given the nearness of time in which we have made these decisions and the risk factors that have been discussed at some length with regard to power cost adjustment mechanisms and other tools, regulatory tools, that mitigate the risk to the company, what's different about PacifiCorp that would persuade us that 8.95% is the proper number for the cost of equity for the utility?

A. Well, I'm not familiar with the record in the other proceedings, so I can't line by line contrast what it is that you looked at in the other proceedings. But what I can say is in reading the decision that was rendered by this Commission in the September 19th, 1986, decision, which is as I understand it the last fully litigated decision regarding PacifiCorp or Pacific Power & Light, a similar issue came up, and the Commission said, and give me a minute, I can find it, but basically what was we're going on the record, as was presented in the particular proceeding, not necessarily going to what we -- not looking at what we did somewhere else.

And if you look at the record in this proceeding, what you have here is you have not only my DCF numbers which come out, if you just look at the DCF or the multistage DCF which is I focused in on a bit more, you get I think the high end of my range was 8.66%. If you look at Mr. Gorman and his DCF, he was 8.9%. If you look at Mr. Hill, his DCF was 9.23%. If you look at Dr. Hadaway and just take his DCF at face value, it was 9.3% on average or 9.5% was the median. If you take the DCF -- and what I think you have to do in interpreting DCF for the reasons I have said in my testimony is cross out any of the GDP growth base numbers. If you do that, you have Dr. Hadaway with a DCF number, I forget exactly but it was somewhere around 8.6%, its an exhibit in my testimony. So you have DCF, DCF, DCF, DCF on this record that supports the 8.95%, so this record solidly supports it from every witness.

Q. Well, let me approach it maybe a different way. If we were to approve your recommended return on equity, how do you think investors would see that our action, given the fact that we have approved significantly higher returns on equity for two other companies within our jurisdiction within the past 12 months, how do you think they would react to that, and do you think we should even care?

A. Well, not being familiar with the information in the record, if there were no other extenuating circumstances, I think it's fair to say that a lower allowed return on equity would cause investors to reevaluate what they would expect from this Commission in the future, how did they get there and why. That's -- but that's part of the process.

And should you care about what investors care -- think, absolutely you should care. But I think you, in caring, what I think is my understanding of your job is to balance the interests of investors and rate payers. And in saying that, which is the standard phrase you've all heard before I'm sure, is it turns out I think that even speaking for rate payers, if the rates you allow are too low, it's not in rate payers' interest and it's not in investors' interest. I wouldn't want to see you have an allowed return of 8% on equity, for example, I think that would be too low, and I think that would cause the company to pull back on making investments that are needed and in the long run be harmful to everybody.

So I'm certainly mindful of that when I make a recommendation. I never want to be in a position of recommending something to a Commission and then saying, oh, darn it, they accepted my number, why did they do that, so. But yes, it would cause a reevaluation if you were at 7% return on equity in the last decision and went up to 9 it would change it, if you were at 15 and when down to 9 it would change the evaluation, sure.

Q. I have just one more question, and it has to do with the -- some of your testimony on the capital structure. And there was some testimony earlier by Dr. Hadaway that -- and I will just kind of state it as I understood it in very broad terms. But essentially the A rating that the company now enjoys is at least in part and perhaps a material part supported by its parent company, Scottish Power. And as I understood his testimony this morning, it was that because Berkshire Hathaway will substitute for Scottish Power at some point in the future, assuming all the approvals are given and the merger is culminated, that it would continue to enjoy the financial benefit of being associated with the very well capitalized venture of Berkshire Hathaway. Now you were here in the hearing room, is that your understanding of Dr. Hadaway's testimony?

A. Yes, I remember him saying that, and I remember him saying something to the tune of $80 or $90 Billion of capital, Berkshire Hathaway, something like that, which I don't know what Berkshire Hathaway's debt equity ratio is or -- I know they own companies like Geico and major investments in Coca-Cola and on and on, certainly I'm not an expert in everything that Berkshire Hathaway owns.

Q. Now what's not in the record, of course, is how much support is being attributed to the parent as to make a difference in how investors view what we do as a regulatory agency here in the state of Washington, particularly with regard to, you know, how PacifiCorp spread throughout six states of which we comprise approximately 8% to 9% of the total company. So I guess my question is, you know, does it really matter what we do with regard to the cost of capital or with regard to the rating agencies, I mean at least within a range?

A. Well --

Q. I mean I guess we can get extreme and then something, you know, that may have an effect, but within, you know, within the range that all the witnesses are talking about here and given the support that's offed by the parent company, does it matter?

A. Well, if you ask me from a point of view of arithmetic does it matter being a small percentage of the total, I have to answer you within the range of what you're likely to do with, no matter how pessimistic or optimistic one becomes, I think I agree with you, it probably doesn't matter.

But I have to elaborate, as I have already said, and I'm obviously not an attorney, but I have been involved in a whole lot of rate proceedings for a lot of years, and I think it would be something that you wouldn't want to do. It's my understanding as a non-lawyer what you legally have a responsibility to do and I think what you want to do, again and to protect both the rate payers and the company, to provide a -- still provide a fair return so that the company will do what it -- not only to meet the legal requirements but also to be confident that the company will do what it needs to to provide the safe and adequate level of service without trying to find shortcuts around it.

COMMISSIONER OSHIE: Thank you, I don't have any other questions.

JUDGE MACE: Commissioner Jones.

COMMISSIONER JONES: Thank you.

E X A M I N A T I O N

BY COMMISSIONER JONES:

Q. Dr. Rothschild, are you participating, are you serving as a capital witness in any other rate cases before other states right now? And if so, what ROE and overall cost of capital recommendations do you have?

A. No, I have been involved in a lot of other things recently, and I have turned down somewhere around 20 requests to testify, so no, I have no other proceedings going on at this time.

Q. Looking at all the other cost of capital witnesses in this case, you appear to be the only one who doesn't go over 10% in any of your analyses; is that correct, you're the only one who consistently is under 10?

A. I don't know, I haven't looked at it that way. If you have looked at it, then I presume you're correct.

Q. I think that's correct, yeah.

Could you go to page 3 of your testimony, lines 7 through 12, and in here -- are you there?

A. Yes.

Q. And in there you discuss the proposed buyout by MEHC and what would happen. Do you -- have you had a chance to review the proposed stipulations entered into on issues involving ring fencing for this proposed acquisition?

A. I am aware of discussions about ring fencing, but no, I have not reviewed the specific proposed settlement.

Q. So has the Staff shared with you any of those proposed stipulations, especially as it affects the disposition of dividends and floors and ceilings beyond which the company is required to go?

A. I don't think it was a question of Staff keeping it from me, but it wasn't a part of what I was asked to look at.

Q. Then my question is, do you still stand by the statement in lines 11 and 12 that says:

> Should the buyout take place, new cost of capital issues might arise for the Commission's consideration at that time.

Do you stand by that statement?

A. Without having read the ring fencing settlements, I would have to say yes. I don't know whether or not I would find other issues, I might or I might not.

Q. But you do recognize that both cases are before the Commission practically simultaneously?

A. Yes, and I'm not -- I have not been asked to provide testimony or analysis on that, so I'm not providing specific advice to the Commission on that.

Q. Let's go to page 11, let's revisit this, pages 11 and 12, this question of financial metrics. I think you answered Commissioner Oshie or somebody on this, but you state the coverage ratio is 2.95%. My understanding of the Standard & Poor's updated in 2004 financial metric is for an A rated company profile 5 that it is in the range of 3.8% to 4.5% for FFO.

A. Well, I think the difference is the benchmark standard versus the median actual.

Q. Yes, and I'm referring to the benchmark standard.

A. Okay, and in the testimony I'm talking -- in my testimony I'm referring -- I'm comparing it to median actual numbers, so we're looking at what Standard & Poor's has really done rather than what they're saying is a guideline that they publish.

Q. So Mr. Williams today, I think we got -- we had some discussion on the record as to the meaning of the benchmarks and the fact the benchmarks have changed, but you are stating here that you would disregard the benchmarks in favor of the Commission looking at the median coverage, what S&P actually does on a median basis?

A. I don't know if necessarily disregard a benchmark. I'm suggesting that the benchmark be looked at as what does Standard & Poor's really do with it, and what does it mean. And I guess, I don't know, I'm just -- just having seen for years the benchmark numbers for most companies tend to be -- most companies tend to get a higher rating than the benchmark, and so I guess what Standard & Poor's is doing is protecting themselves perhaps to be able to point in discussion to the company, well, we have already given you a higher bond rating than the benchmarks say. So what we care about, of course, is what's really going to happen, not what some benchmark says. If it was the other way around where for whatever silly reason benchmarks were consistent with triple A and the company is getting triple B, well, it's not what the benchmark says, it's the rating that matters.

Q. I understand.

Were you here this morning when Mr. Williams and I had a discussion about his computation of the benchmarks using your proposed 43.5% cap structure and your ROE of 8.95%?

A. Yes.

Q. Did you hear that discussion?

A. I did.

Q. Have you had a chance to review the company's or his analysis of that methodology in which they came up with a projection of an FFO to interest coverage of 3.9x?

A. I have not tried to reproduce his

computations, no.

Q. Do you have any comments for the record at this time on his computation?

A. I haven't, as I say, I have not -- I can not give you a detailed response to his computation, I have not tried to reproduce them. What I would point out is that the coverage ratio number that will come out of my recommendations as I have provided in my testimony, that number tends to be a very important one. I'm not saying the others aren't important too, but that one tends to be the most important. And so if that's in line, then other things tend to work out. The number tells you how much of a cushion the company has to service its debt, and that's the number that I presented. And not only that, I'm not talking about a capital structure that's different than the company has been able to implement and use for four, five years.

Q. No, I understand that point.

A. Okay.

Q. You have made it.

A. Right. But no, I have not gone through his -- I can't tell you whether I think his computations are correct or incorrect, I have not tried to reproduce those.

COMMISSIONER JONES: That's all I have, thank you.

JUDGE MACE: Chairman Sidran.

CHAIRMAN SIDRAN: Thank you.

E X A M I N A T I O N

BY CHAIRMAN SIDRAN:

Q. It's a little after 5:00, so I have what I hope is a short question, and it's really following up Commissioner Jones' question about the potential effect of MEHC's acquisition of PacifiCorp. You were here I believe during my questioning of Dr. Hadaway, were you not?

A. Yes, I was.

Q. I have the same question for you that I asked him. Does the -- let us assume that this merger takes place, would that have any effect on the analysis in your testimony?

A. It could. The bond rating and the results that occur from that, I think it's a question of looking at it as the weakest link in the chain. And if the parent company should become a lot weaker or a lot stronger, it could result in a change in the bond rating for PacifiCorp. It's more of a risk if the parent gets a lot weaker, because then that would be the weaker link in the chain if that happened.

I know that if you look at MEHC at face value, it has a very highly leveraged capital structure. I heard Dr. Hadaway saying that the plan was to collapse that and bring that into Berkshire Hathaway. I don't want to mislead you into saying that I have done that analysis to know what would happen if MEHC went away and Berkshire Hathaway were -- because I don't know, I haven't done that, but I would suggest to the Commission that it look at that closely and be satisfied that the company would be okay.

And also another thing which I think is worth considering is that in terms of ring fencing, I think ring fencing if done properly can be an appropriate safeguard, but I don't think that -- I wouldn't like to see the Commission confuse ring fencing with saying, well, okay, if we lock in whatever common equity ratio we do that that would automatically mean it was the fair and economical number to use. If you had a ring fence at 35% or 40% common equity, for example, that might provide a sufficient safety net, and perhaps the company's common equity ratio should still be 43%, 44%, 45%, 48%, whatever the numbers might show. And conversely, if the ring fence were set real high, that might be okay because rate payers are sufficiently protected, that doesn't mean for rate making purposes if the ring fence were 55% common equity that that would exclude necessarily a 45% or 40% or 35% common equity ratio if it was justified.

Q. Okay. So I'm asking these questions, I'm going to ask the same questions of the cost of capital witnesses, we asked this question at the beginning of this hearing, everyone's analysis is based on something that is almost certainly not going to be true, which is Scottish Power owning PacifiCorp at the time we have to make our decision.

A. Right, I understand that.

Q. So I take from your answer you believe that it would make a difference or could make a difference to your analysis if the parent company was MEHC; is that right?

A. It could. I could be concerned that if MEHC should be sufficiently weak that it could result in a bond downgrading that it's conceivable that, and the ring fence didn't protect that, it's conceivable that the cost of the capital structure to use might appropriately contain less common equity. And in response to that, lower common equity might result in a higher cost of equity recommendation and eventually a higher cost of debt. So I mean that's possible, and other alternatives are possible as well.

CHAIRMAN SIDRAN: Thank you, that's all.

JUDGE MACE: Let's deal with this Exhibit Number 170. Mr. Trotter, you reserved, you asked me to reserve ruling on that.

MR. TROTTER: Yeah, Your Honor, I won't object to it, but I will ask that the Commission include in the record a complete copy of the order and the settlement agreement in that docket. I have copies here.

JUDGE MACE: Very well, can we have that become Exhibit 170 then?

MR. WOOD: Certainly we have no objection, Your Honor.

JUDGE MACE: Admitted.

Thank you, Mr. Rothschild, you're excused.

THE WITNESS: Thank you very much.

MR. TROTTER: Is the witness excused, Your Honor?

JUDGE MACE: Yes, you're excused, thank you.

I think that that concludes the witnesses we were going to hear from today.

The only other item that's outstanding is, Mr. ffitch, I wondered if you wanted to offer that public testimony exhibit at this time or whether you wanted to wait on that.

MR. FFITCH: No, thank you, Your Honor, yes, we would like to offer that at this time. We have provided copies to the Bench and the parties who are in the hearing room.

JUDGE MACE: So I believe everybody has a copy then, and that's Exhibit Number 721, is there any objection to admitting this exhibit at this time?

MR. WOOD: A clarification question in this case since we haven't read it, does this exhibit consist entirely of letters from the public related to this case? I want to make sure I'm understanding what it is I'm not objecting to.

MR. FFITCH: Well, if you look, there's actually a document, a cover document that states that consists of letters, E-mails, and other written materials submitted by the public to provide comment on for the general rate case, and these were submitted to the Commission or to the Office of Public Counsel either via mail or at the public comment hearing in Yakima.

MR. WOOD: Based on that representation, we have no objection, Your Honor.

JUDGE MACE: I would admit Exhibit 721.

MR. FFITCH: The only thing I will note, Your Honor, is as I was just looking at this exhibit, there may be some duplication between materials that were submitted by members of the public both at the Yakima event and also submitted by mail. So I think that's obvious from looking through this, I just happened to see one, let me see if I'm right about that. Actually I stand corrected, I thought there was a duplication between the two categories, but apparently I was mistaken, it looks like it's all right, so.

JUDGE MACE: Very well then.

Is there anything else we need to address before we adjourn?

I want to make sure everybody knows that we're back on the record on February 2nd, and I believe Judge Rendahl talked about an 8:30 prehearing conference to deal with cross-exhibits, so if you will be here at that time, that would be helpful.

Anything else?

All right, we're adjourned, thank you.

(Hearing adjourned at 5:15 p.m.)